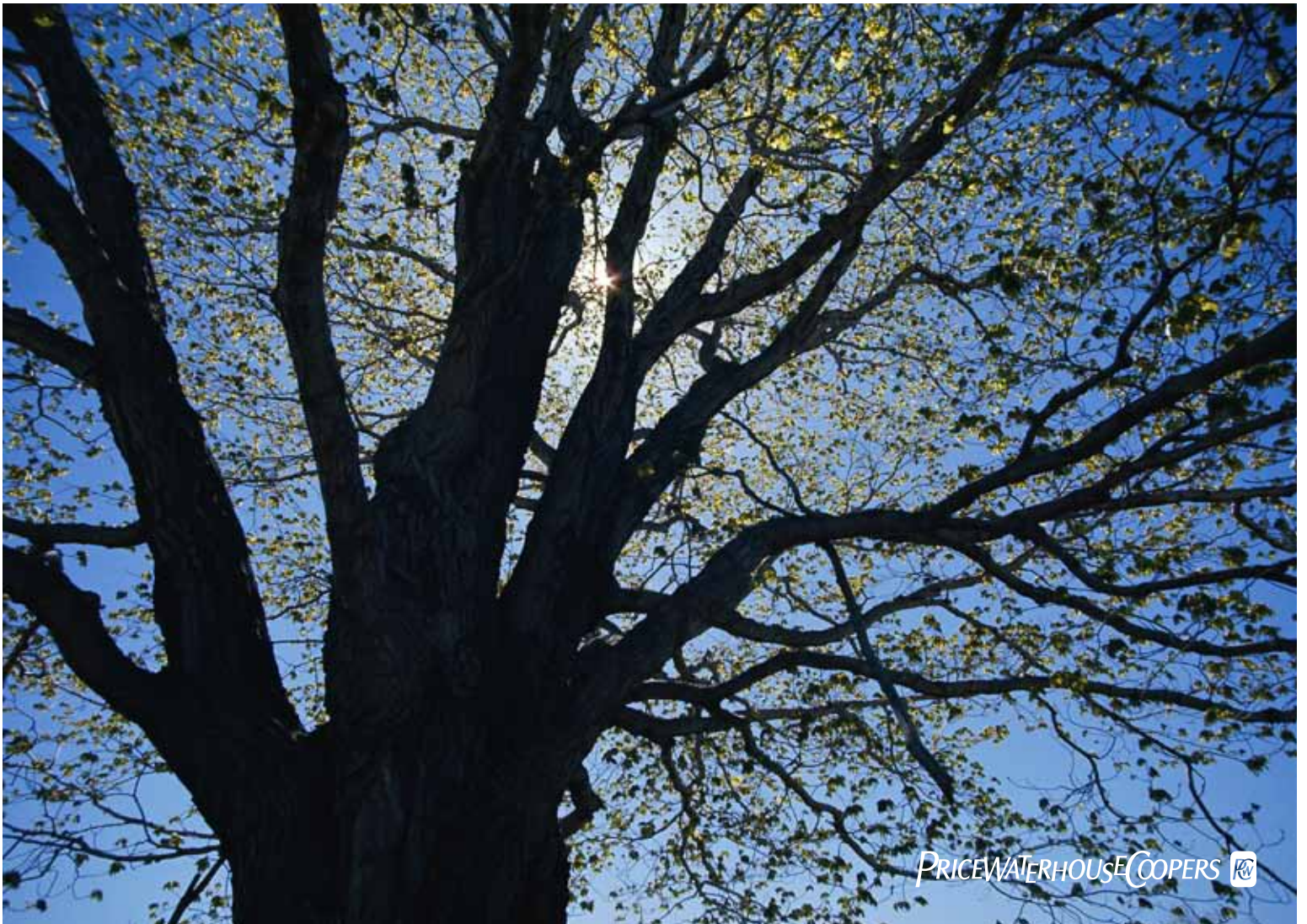


Equity for all? Challenges and controversies with equity-based compensation

Transfer pricing perspectives

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Businesses have used equity-based compensation, including stock options, the granting of restricted stock, phantom stock plans, and other employee stock plans, to motivate employees and align employee goals with the goals of the shareholders in maximising shareholder value.

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Introduction

Equity-based compensation is a mainstay in many businesses' incentive plans. Over time, it has become a hot issue in transfer pricing on a global basis. Guidance and consistency in how equity-based compensation should be treated internationally are lacking, creating significant controversy between taxpayers and taxing authorities as well as among taxing authorities.

Background

Businesses have used equity-based compensation, including stock options, the granting of restricted stock, phantom stock plans, and other employee stock plans, to motivate employees and align employee goals with the goals of the shareholders in maximising shareholder value. Equity-based compensations in the form of stock options have become prevalent, largely because they benefit employees only when the stock price of a company increases. From a shareholder perspective, there is only a dilution of share value and not an actual cash cost on the exercise of stock options by employees. There is also no out-of-pocket cash cost to the company issuing the stock options, although arguably there is an opportunity cost to the extent that these options are issued at a significant discount over market prices. The use of options peaked in 2001 for Standard and Poor's 500 companies with options granted, representing approximately 2.5% of outstanding shares. Since then, the burst of the dot.com bubble, the change in accounting standards, and public perceptions of large option gains of upper management have resulted in a 16% annual decrease in the granting of stock options among S&P 500 companies to 0.8% of outstanding shares in 2007.

Although there is no cash outlay, International Financial Reporting Standards have adopted the expensing of all equity-based compensation on financial statements in 2005, and US generally accepted accounting principles (US GAAP) adopted expensing equity-based compensation in 2006. These accounting standards require that the fair market value (FMV) of the options be determined at the time of grant and expensed based upon the amortisation of this equity-based compensation over the period for which the option vests for the employee. The expense generally is included with the relevant cost centres to which they relate. These accounting guidelines are flexible on how FMV is established; however, most companies apply the Black-Scholes option pricing model to determine their option expenses for financial statements.

Conversely, for income tax deductions, the United States and most other countries that allow any deduction for options use the spread at exercise as the basis for the expense as opposed to grant date valuations. The spread at exercise requires that the stock price increase and the option be exercised for a tax deduction to be recognised. As such, the tax deduction can diverge significantly from the FMV in both the amount and timing of the expense.

Transfer pricing guidance

Although the use of equity-based compensation and the accounting for such compensation have evolved in business, guidance is limited on how options impact transfer pricing. The US cost sharing, services, and comparable profit method sections of the transfer pricing regulations provide specific rules and guidance, but the Organisation for Economic Co-operation and Development (OECD) has issued broad guidance that leaves a lot to interpretation. Many tax authorities are developing their interpretation of the OECD guidance, which is likely to lead to inconsistent positions and double taxation. For example, the US regulations contain a number of inconsistent positions.

US transfer pricing regulations

The US regulations have adopted the view that equity-based compensation is a cost for transfer pricing purposes. These regulations followed the IRS field and Tax Court positions that equity-based compensation should be a cost for purposes of determining costs to be shared under a cost sharing arrangement (CSA). This treatment of equity-based compensation as a cost was introduced in the United States as part of the cost sharing regulations and comparable profits method (CPM) regulations in 2004. Under these regulations, the default position is that the spread at exercise is the cost that should be included in the cost pool for intangible development activities within the scope of a CSA. Taxpayers can, however, elect to use the accounting expense when the equity-based compensation is in a regularly traded stock on a US securities market and under US GAAP or consistent with US GAAP.

The US temporary regulations for services clarified the IRS intent that total services costs should include stock-based compensation for cost-based services methods (e.g., cost of services plus method, services cost method, and CPM). Unlike the cost sharing regulations, the temporary services regulations indicate a preference on the part of the IRS to use a grant-date valuation methodology. Again, this is an inherent divergence, in both timing and value, in how costs should be treated from the cost sharing transactions for which a taxpayer has not made an election or is not able to make an election, to the service regulations where an option to elect how equity-based compensation expense should be measured is not explicitly offered.

In relation to tangible and intangible property transactions, the US regulations for the application of the CPM also address equity-based compensation. Although not as definitive as the cost sharing or services regulations, the CPM regulations state that “it may be appropriate” to make comparability adjustments for material differences in utilisation or accounting for stock-based compensation between the tested party and the comparables. This essentially requires that equity-based compensation be included, excluded, or adjusted in both the tested party and the comparables’ financial data for the purposes of applying the CPM. Although not specifically addressed by the US regulations, the consistency in accounting provisions of the resale price method and the cost plus methods also would require that equity-based compensation be considered.

Unlike the US regulations, however, the OECD introduces certain caveats on the inclusion of the equity-based compensation in intercompany transactions.

OECD guidance

The OECD published “Employee Stock Option Plans: Impact on Transfer Pricing” on September, 3, 2004, which addresses equity-based compensation. The paper starts with the premise that options are an element of employee remuneration and a cost to the employer issuing the option, not an equity interest or a dilution of interest of the shareholders of the company. It concludes that it is a cost for transfer pricing purposes for the application of the cost plus method, profit split method, and transactional net margin method (TNMM) as well as in cost contribution arrangements (CCAs). The OECD paper specifically reviews the following three situations:

1. The provision of options by a parent to subsidiaries’ employees: The paper concludes that this is a cost, and the FMV should be used for a dilutive share option or the actual cost (spread at exercise or cost to purchase the option) where the parent actually purchases the shares or option in a third-party transaction.
2. The inclusion of options in service, intangible, and tangible good transactions: The paper concludes that these options are a cost and need to be considered for the application of the cost plus, profit split, and TNMM. For consistency in accounting, the FMV generally would be used to determine the cost. However, the resulting price would need to be reflective of an arm’s length price.
3. The inclusion of options in CCAs: The OECD paper concludes that these options are costs that should be included in CCAs, even though there is no direct evidence of parties at arm’s length including these as costs. The OECD believes that the lack of evidence of arm’s length relationships of sharing options costs is a result of prior accounting standards, the overall economics of the arrangements, and natural setoffs between parties in joint venture arrangements. In the conclusion, the paper discusses a hypothesis on what arm’s length parties would do. This is a deviation on the OECD’s traditional reliance on actual evidence of arm’s length transactions in applying the arm’s length principle.

Unlike the US regulations, however, the OECD introduces certain caveats on the inclusion of the equity-based compensation in intercompany transactions. It concludes that the costs must be reasonable and, when included, reflect the arm’s length price for the property or service under examination. This would indicate, for example, that in situations where significant options expenses are incurred by the controlled entity but not by an uncontrolled entity, and other aspects of underlying compensation are the same as the general market, comparability adjustments would need to be made to include only a portion of this equity-based compensation or that cost-based methods are not as reliable as other methods.

Other guidance

Other countries have provided limited guidance on how options should be treated. In Canada, the Canadian Revenue Authorities (CRA) have indicated in informal public statements that option expenses included in service charges and CCAs may be nondeductible. The CRA has also informally noted that the underlying costs become a service fee and that you should not look through to the underlying costs any more than you would look at the underlying costs when you receive a bill from arm's length parties. However, one must examine the value of the service rather than the underlying costs. In these circumstances, the CRA may limit the quantum of stock option costs included in a service fee to an amount it considers reasonable based on the benefit provided.

The Australian Tax Office (ATO) recognises a connection between the cost or value of employee stock incentives and the cost or value of the employee services remunerated by the incentives. However, no specific guidance is provided, and deductibility of the service charge clearly will depend on the benefit received from the services provided and whether the cost allocation is appropriate.

Similar positions have been adopted informally by other countries. Several countries do not allow a deduction for equity-based compensation or do not recognise equity-based compensation as a cost that arm's length parties would pay. Furthermore, they may challenge the amount of the cost for equity-based compensation as they may consider that the accounting treatment estimate or spread at exercise is unreliable in determining actual costs or the market value of the employees' services.

Impact on taxpayers

For cost-based methods, the guidance outside of the United States leaves open the question whether, and to what extent, equity-based compensation would be included in arm's length arrangements. In the Xilinx US Tax Court case, the taxpayer provided a volume of evidence that parties at arm's length would not share in the equity-based compensation in joint ventures and cost-based service arrangements. This evidence included service contracts with the US government under federal acquisition regulations that did not allow any expense related to equity-based compensation to be included in cost-based contracts. The Tax Court held that the government had not established, through evidence, that parties acting at arm's length would include equity-based compensation and could not accept the hypothesis that it would be based upon economics. This decision further calls into question the OECD paper's conclusion in respect of CCAs, which relies on the hypothesis that parties acting at arm's length would share such costs. The OECD only provided reasons why direct evidence that arm's length parties share equity-based compensation costs may not have been available as opposed to evidence of arm's length parties actually do share such costs.

In applying the CPM/TNMM for all transactions, taxpayers will need to account for options for comparability purposes and make reliable adjustments for equity-based compensation. The following table demonstrates the impact that equity-based compensation may have in a situation where both parties have the same operating margin after an expense for equity-based compensation has been accounted for but significantly different operating margins before equity-based compensation.

	Operating margin before ESOP expense	Operating margin after ESOP expense
Tested party subsidiary distributor	5%	3%
Median of comparables sample	3.5%	3%

This example raises a number of questions when undertaking a CPM/TNMM analysis:

- Does the disparity in equity-based compensation levels mean that the CPM/TNMM is not reliable? At which point does the inclusion of equity-based compensation in order to increase comparability reflect a true divergence in functions and risks that would render the comparison less reliable?
- Are options attributable to function being tested? For example, the value of equity-based compensation granted to employees of the distribution arm of an integrated multinational would not reflect solely the contribution of their efforts to the equity value of the company. By contrast, the same employees at an independent distribution company would receive equity-based compensation that reflects solely on the performance of the distribution operation.
- Will this divert the underlying transfer price from the arm's length standard?
- Are the underlying compensation expenses excluding equity-based compensation comparable for the functions performed? For example, if equity-based compensation is properly viewed as a substitute for other forms of compensation, then one would expect to find that employees of the comparable companies are receiving less in salaries than employees of the tested party for performing the same function.

In the example above, the tested party's taxable income increases to 5% of sales if equity-based compensation expense is nondeductible. Even if equity-based compensation expense is deductible, depending on the timing and amount that can be deducted, this adjustment may result in a significant divergence and uncertainty between income subject

to tax and operating income under the CPM/TNMM analysis. Similar results would occur in service transactions for which there is a question on deductibility or a divergence in the amount and timing of the deduction. In such cases, taxpayers need to consider how the parent company should structure the equity-based compensation recharges to offset additional tax. Also, taxpayers will need to consider the character, timing, and actual amount that should be charged to optimise their global tax position.

Given the limited and contradictory guidance and evidence on the treatment of equity-based compensation, taxpayers may be well advised to develop a methodology for deriving an actual cost of equity-based compensation rather than an estimate or change in the way that transfer pricing is determined. This would be the case where significant equity-based compensation is involved to ensure intercompany transactions are fully deductible and the underlying transaction value is consistent with the arm's length standard. Companies should also further examine their intercompany agreements and revise them, if necessary, to reflect the actual policies they adopt and ensure that references to accounting standards for determining costs are consistent with how they treat equity-based compensation.

The potential is high for tax disputes and double taxation surrounding the impact of equity-based compensation, given the uncertain treatment by multiple tax authorities. Accordingly, taxpayers should consider the impact of their tax reserves and available avenues to resolve dispute. Bilateral advanced pricing agreements are one way to achieve some certainty in this respect and reach agreement between tax authorities. Carefully established positions, including when and how much of the equity-based compensations should be included in intercompany transactions, together with clear and concise documentation and consistent treatment of equity-based compensation across all transactions, also will assist in taxpayers being able to defend their positions on a global basis.

Conclusion

The inconsistent treatment of equity-based compensation regarding transfer pricing and tax deductibility raises significant challenges for taxpayers in managing their global transfer pricing and global taxes. The evolution of guidance on equity-based compensation means that these challenges need to be addressed proactively to optimise a taxpayer's tax position and manage exposures. In developing their strategies, taxpayers should examine their provision of equity-based compensation to employees to align the deductibility of such compensation with the potential income from intercompany transactions. Taxpayers also should ensure that their intercompany agreements are consistent with actual policies adopted to ensure that a cohesive strategy to deal with this uncertainty is developed. Furthermore, as the impact and guidance on the impact of equity-based compensation evolves, controversy in this area will increase, and taxpayers will need to continually review, manage, and take advantage of global controversy avenues available to them.

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