



# What are the international tax and transfer pricing considerations for equity-based incentive compensation?

Global Equity Compensation Alert

Global Tax News

29 MAY 2013

By: Joy Dasgupta | Dean Fealk

Equity-based incentive compensation (also called stock-based compensation) generally consists of the grant of stock options or “whole share” awards to an employee or an independent contractor. Equity-based incentive compensation plans allow recipients to gain an ownership stake in the company. By offering share ownership in the company, employers not only reward employees but provide them with a valuable complement to traditional cash-based compensation packages.

As companies continue to expand globally, equity-based compensation is increasingly offered to employees located in countries other than the country where the stock award issuing company is located. For example, R&D employees employed by an Indian subsidiary of a US parent can receive stock options issued by the US parent and exercise them after the options have vested.

Cross-border issuance of equity-based compensation can lead to a number of cross-border tax and transfer pricing issues for multinational companies. For example:

- Can the foreign subsidiary receive a deduction on its tax returns for equity-based compensation issued to its employees by the US parent?
- What payment, if any, should be made by the foreign subsidiary for equity-based compensation received by its employees?
- Can costs associated with equity-based compensation be shifted to foreign subsidiaries? If so, what are the local tax, accounting and regulatory obligations of the foreign subsidiary?
- Can transfer pricing be affected by equity-based compensation, and, if so, what is the impact?

In this article, we briefly discuss some of the key international tax and transfer pricing issues that typically arise when equity-based compensation is provided by multinational companies to employees of its foreign subsidiaries.

Our discussion assumes that the company issuing the stock awards is the parent-issuer resident in the United

States, although much of the discussion is equally applicable when the parent-issuer is resident in another country.

## **I. About equity-based compensation**

### **A. Background**

The practice of granting a company's employees, officers and directors equity-based compensation is widespread among US businesses. Equity-based incentive compensation awards come in many forms and include the following:

- Stock options (qualified and non-qualified)
- Restricted stock
- Restricted stock units
- Performance-based stock shares
- Stock shares
- Stock appreciation rights
- Purchase rights under employee stock purchase plan (qualified and non-qualified)

Employee stock options are contracts granting employees and officers (and sometimes directors and other service providers) the right to purchase the company's shares at a specified exercise price after a specified vesting period. The exercise price is typically the market price of the stock when the option is granted; the vesting period is generally two to four years; and the option is usually exercisable for a certain period, often five or 10 years. The value of the option lies in the prospect that the market price of the company's stock will increase by the time the option is exercised. If the price falls, the option will simply not be exercised; the contract does not obligate the employee to buy the stock. Employee stock options typically cannot be transferred and consequently have no market value.

Some stock awards have special features designed to do more than just increase incentive value. Some, such as purchase rights with respect to employee stock purchase plans, are granted at less than the market value of the stock, to make it more beneficial for recipients to purchase shares. "Premium" options are granted at a price higher than the current price of the stock; "performance-vested" options typically are not exercisable until a specific stock price is reached. "Indexed" options are re-priced based on broad stock indices, to differentiate between the company's performance and the market's performance. There are other variations.

In addition to stock options, direct grants of stock or "whole share" awards such as restricted stock and restricted stock units are also common, and can be hedged with restrictions similar to those governing the exercise of options. "Phantom stock" and stock appreciation rights typically pay recipients the cash equivalent of the fair value of the shares or the increases in the company's stock without actual share ownership.

Since a vast majority of equity grants are in the form of stock options, that is the primary focus of this article. The valuation methods we refer to are typically used for valuing stock options.

### **B. Key events in issuance of equity-based incentive compensation**

From the standpoint of financial reporting and tax accounting, three key events occur with respect to stock options. First, recipients are granted stock options on a specified date – this is called the "grant date."

Second event is the vesting date when the stock option vests and becomes available for exercise by the recipient.

Third key event is the exercise date when the recipient elects to exercise the stock options – this is called the "exercise date." At the time of exercise, the recipient exercises the stock option and receives the underlying shares. However, in practice, the shares may be sold immediately and, in such case, the difference between the market price and the exercise price is received in cash by the recipient.

When recipients exercise their stock options, the company provides the shares to the employee by either

purchasing the stock from the market, through treasury stock, or by newly issued shares. In each of these scenarios, the base cost to the company is the difference between the market price and the exercise price.<sup>1</sup>

### **C. Financial reporting and tax aspects of equity-based incentive compensation**

Issuance of equity-based compensation has both financial reporting impact and tax implications. When a US company issues equity-based compensation to its employees, it must recognize that compensation in its financial statements by recording a book expense in relation to issued equity-based compensation. Rule FAS 123 requires companies to estimate the value using an option pricing model and show that amount, called the “fair value,” as a cost over the period until the options are vested (this is also called the grant-date method under the US transfer pricing regulations).

The US Internal Revenue Code recognizes two types of options. The first is called “statutory” or “qualified” options, because these are accorded favorable tax treatment if they meet the Code’s strict qualifications. Generally, these options are not taxed to the employee nor deducted by the employer.<sup>2</sup> The second type of option is “nonqualified” options, which are taxed to the employee as wage income upon exercise. The spread between the market price and the strike price is deductible to the employer when the employee includes the proceeds from the exercise in income.

For tax purposes, stock options are expensed at the time they are exercised. This expense is determined on the basis of the “spread-at-exercise method,” which is essentially the difference between the exercise price and the fair market value on the date of exercise. Often, there is divergence between the grant-date value and the spread-at-exercise value, depending on the performance of the company’s stock.<sup>3</sup>

## **II. International equity award grants**

In the case of international stock option grants, awards are issued to employees on the payrolls of the company’s foreign subsidiaries. Thus, the cost of the equity issued is initially with the US parent. That is, when the granted stock options have vested and are exercised, the US parent would have to incur the cost associated with exercise. But the cost of equity compensation awards granted to non-US employees is not deductible in the US under the US tax laws and thus, offers no tax benefit to the US parent.

In certain circumstances, it may be tax advantageous to push down the cost to a foreign subsidiary where a deduction can be claimed.<sup>4</sup> This result, which also better aligns the costs expended on the stock options with the benefits received by employees working for a foreign subsidiary, can be achieved through a “Stock Recharge Agreement,” which is an agreement between a US parent corporation and a foreign subsidiary whereby the foreign subsidiary agrees to reimburse the parent corporation for the costs associated with equity-based compensation issued to its (*i.e.*, the foreign subsidiary’s) employees. Figure 1 illustrates the sequence of payments.

### **Figure 1: Payment sequence under a recharge agreement**

In the first step of the sequence, the US parent grants equity-based compensation to the employee of a foreign subsidiary. Under the recharge agreement, the US parent recharges the equity-based compensation to the foreign subsidiary. The amount of the recharge should be determined keeping in mind local country regulations as well as transfer pricing considerations. When stock options are exercised, the employer’s cost of the exercised equity is then absorbed by the foreign subsidiary (absent the recharge, the US parent would have absorbed this cost).

## **III. Tax impact of recharging**

If the US parent and subsidiary corporations comply with requirements set forth by regulations issued under Section 1032 of the Internal Revenue Code, the recharge payment will be treated for US tax purposes as payment to the parent corporation in consideration for its stock. This means the recharge payment will not be taxable to the parent corporation as a dividend or otherwise, and serves as a mechanism to repatriate cash to the US.<sup>5</sup>

From the US perspective, the US parent can use either the grant-date method or the spread-at-exercise method to

determine the value of the stock options costs for purposes of recharging. Under the spread-at-exercise method, the value is determined on the date of the exercise and is based on the difference between the market value of the stock price and the exercise price.

The grant-date method could also be used, which as noted above, follows the fair market value principles and is calculated on the date of the grant. However, it bears noting that Section 1032 regulations follow the spread-at-exercise method, and to that extent using the grant-date method may result in some tax implications.

Foreign subsidiaries may be able to claim a deduction for the payment for equity-based compensation under a recharge agreement. However, local tax and accounting requirements differ in what forms of compensation are eligible, the value of the compensation that can be deducted, and accounting requirements. Some countries, such as the UK, provide statutory deductions irrespective of any cost in the local entity (*i.e.*, without a recharge agreement). Many countries allow a corporate deduction if the local entity recognizes an appropriate expense (*i.e.*, as reflected in a recharge agreement). Further, in certain countries the deduction may only be available for shares purchased in the open market and not for newly issued shares.

Other countries, such as the Netherlands, generally do not allow a deduction even where there is a local entity expense. Furthermore, in certain jurisdictions, such as China, recharge may not be possible for foreign exchange control reasons. Companies should evaluate both legal considerations and the tax effect that a stock recharge arrangement would have in the foreign subsidiary's jurisdiction; this includes determining whether the foreign country permits a tax deduction for such stock recharge payments and whether foreign withholding taxes apply.

The Appendix below summarizes local tax and accounting requirements applicable to the deductibility of recharged costs in Australia, Brazil, Canada, China, Germany, Hong Kong and the United Kingdom.

In the experience of the authors, companies equally use the grant-date method and the spread-at-exercise method to determine the cost of stock options in recharging equity-based compensation. The grant-date method is generally considered to be more consistent with the arm's-length standard because it is an *ex-ante* value, but the spread-at-exercise method is more closely related to actual cost incurred by the company, which is more consistent with tax accounting. Due care should be taken in choosing the method for recharging costs because it also impacts transfer pricing relationships (as discussed below).

#### **IV. Transfer pricing implications of recharging**

Although the grant of equity-based incentive compensation to employees of overseas subsidiaries has limited direct tax implications from the US standpoint, it can have a bearing on intercompany pricing, which could result in additional cost burden on the foreign subsidiaries and also indirectly affect the tax liability of the US parent.

Depending on the transfer pricing relationship, foreign subsidiaries can be broadly categorized into two groups: 1) Limited Risk Entities (LRE) that are limited risk operations and compensated with a certain guaranteed level of profits;<sup>6</sup> or 2) Risk Bearing Entities (RBE) that operate as entrepreneurs and whose profits are linked to market performance but are not guaranteed.<sup>7</sup>

##### **A. Recharging to an LRE**

First consider the case of an LRE that is provided a guaranteed level of profit through a cost-plus payment by the US parent, illustrated in Figure 2.<sup>8</sup> If equity-based compensation is recharged from an LRE, its operating costs may increase due to the cost of the recharged grants.<sup>9</sup> Because the foreign subsidiary is guaranteed a certain level of profit, the payment provided by the US parent should be such that the local subsidiary's target profit levels are met. This implies that the recharged cost is essentially passed back to the US parent through the payment that the US parent provides to the local subsidiary.

Alternatively, if the LRE is compensated by a foreign principal, the foreign principal may absorb the cost of the recharge through the payment provided to the LRE.

#### **Figure 2: Impact of recharge on intercompany pricing of LREs**

If the foreign subsidiary is an LRE and requires a guaranteed level of profit, then the deductibility of recharged equity award costs provides no additional tax benefit to the foreign subsidiary. In fact, if the foreign subsidiary is compensated on a cost-plus basis, then the cost of recharged equity-based compensation award costs increases the cost base and results in higher required profits, and thus increases the tax burden to the foreign subsidiary.

However, if the payment made by the US parent to the foreign subsidiary is deductible in the US, this higher tax burden may be offset by lower taxes for the US parent. In effect, the cost of equity-based compensation that is pushed down to the foreign subsidiary is round-tripped back to the US parent via the payment to its foreign subsidiary. This effectively allows the US parent to get the same benefit from the deduction that it would have lost had it not recharged the equity grants.

The cost of equity-based compensation included in the cost base becomes important in this scenario because the compensation to the LRE is based on the cost base of the LRE. Companies can use either the grant-date method or the spread-at-exercise method in this regard.

#### **1. Grant-date method**

There is a bias in favor of using the grant-date method for determining the value of equity compensation costs because it is considered to be consistent with the arm's-length standard. That is, unrelated parties negotiate prices *ex-ante* on the basis of expected costs likely to be incurred. Thus, pricing takes into account the grant-date value of any equity-based compensation that the company expects to offer to its employees. Indeed, unrelated parties typically do not adjust prices on the basis of actual stock price performance.

This is also reflected in the financial statements released by the companies that disclose the grant-date value of equity-based compensation given to its employees. In other words, the financial performance disclosed to investors, which forms the basis for their investment decisions, includes the grant-date value of equity-based compensation.

However, issues can arise in using the grant-date method because the local tax deduction, if allowed, typically follows the spread-at-exercise method, which can produce a materially different value from the grant-date method. This can result in lower than desired level of profitability if the value under the spread-at-exercise method is higher than the value under the grant-date method. On the other hand, if the spread-at-exercise method value is lower than grant-date method value, it may result in higher-than desired level of profits in the LRE. Thus, the profitability of the LRE can deviate from the desired level of arm's-length profitability.

This suggests that the LRE should only claim a local tax deduction equal to the grant-date value so that consistency between costs and revenue is achieved. However, this may not be possible in all countries.

#### **2. Spread-at-exercise method**

The advantage of using the spread-at-exercise method in pricing intercompany fee is that it ensures consistency between the deduction available and the payments that that the LRE will receive and therefore the LRE is more likely to achieve the target level of profitability.

Another advantage of the spread-at-exercise method is that the cost plus fee paid by the US parent (or the foreign principal) to the LRE may be deductible to the US parent (or the foreign principal). Thus, equity compensation award costs, which were not deductible by the US parent (or the foreign principal) effectively may become deductible through the service fee paid by the US parent (or the foreign principal).

However, some practitioners believe that the spread-at-exercise method deviates from the arm's-length standard because transactions between unrelated parties are not priced *ex-post*. Further, over an extended period of time, the values under the two methods are likely to converge, and the corresponding tax liability is likely to be similar under both methods. Thus, using the spread-at-exercise method is viewed as an unnecessary deviation from the arm's-length standard.

Another peculiarity associated with the spread-at-exercise method is that in certain situations the spread can be substantial due to a run up in the stock price (this happens most often in the case of a startup company going public). Correspondingly, the cost base and the plus can be also be substantial resulting in an increase the tax burden of a cost plus LRE. In such situations, it may be more optimal to recharge the equity-based compensation to a foreign principal

In conclusion, neither method is perfect. Taxpayers should evaluate and choose a method taking into consideration the anticipated results. More importantly, taxpayers should stick with the chosen method to ensure consistency.

## **B. Recharging from an RBE**

When the local subsidiary is an RBE whose profits are determined by the performance of the business, and the costs from the recharged equity grants are deductible, the tax burden is reduced because the profits are lower due to the recharged costs. This is shown in the figure below.

### **Figure 3: Impact of recharge on intercompany pricing of RBEs**

The RBE is often a full risk principal located in a low-tax jurisdiction. In those situations, even if the recharged costs are deductible, the tax benefit is less because the local subsidiary is in a low-tax country. However, even if the tax benefit is low, recharging is useful as it allows repatriation of cash from the foreign subsidiary (where cash is likely to accumulate because it is a full risk principal).

## **V. Impact of stock-based compensation on cost sharing and intercompany service fees**

The US transfer pricing regulations have adopted the view that equity-based compensation is a cost for transfer pricing purposes. The cost sharing regulations clarify that equity-based compensation should be taken into account in determining the operating expenses treated as intangible development costs of a controlled participant in a qualified cost sharing arrangement under Treas. Reg. § 1.482-7. Similarly, the intercompany services related regulations also clarify that equity-based compensation should be included in the cost base for purposes of determining chargeable costs.

Under the cost sharing regulations, the default position is that the value of equity-based compensation using the spread-at-exercise method is the cost that should be included in the cost pool for intangible development activities within the scope of a cost sharing arrangement. Taxpayers can alternatively elect to use the grant-date method when the equity-based compensation is in a regularly traded stock on a US securities market. Again, the key is to choose a method and use it consistently.

The US transfer pricing regulations pertaining to pricing of intercompany services also clarified the IRS intent that total services costs should include equity-based compensation for cost-based services methods (e.g., cost of services plus method, services cost method, and comparable profits method (CPM)). While the services regulations do not endorse any particular method, the examples provided use the grant-date method.

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 utilization or accounting for equity-based compensation between the tested party and the selected comparable companies. This essentially requires that equity-based compensation be included, excluded, or adjusted in some manner in both the tested party and the comparable companies’ financial data for the purposes of applying the CPM.

## **VI. Ensuring your strategy is cohesive**

Equity incentive compensation granted to employees located in foreign countries can lead to a number of tax, accounting and transfer pricing issues. Many of these issues result from the local regulations applicable to the recharge of equity compensation costs, while others arise due to transfer pricing relationships. Because these

implications are closely related and interconnected, multinational companies should clearly understand the impact from the US tax and financial reporting perspective, as well as from the standpoint of foreign country obligations.

In developing their strategies, multinational companies should examine of the way they provide equity-based compensation to employees in order to align the deductibility of such compensation with the potential income from intercompany transactions. Companies also should ensure that their intercompany agreements are consistent with actual policies adopted to ensure a cohesive strategy to deal with this uncertainty.

For more information about cohesive strategies for equity incentive compensation, please contact Joy Dasgupta and Dean Fealk.

## **APPENDIX: LOCAL COUNTRY TAX AND ACCOUNTING REQUIREMENTS\***

### **Australia**

A local tax deduction may be available if a recharge agreement is in place.

### **Brazil**

A local tax deduction may be available if a recharge agreement is in place. However, foreign exchange restrictions limit the ability to recharge equity compensation costs. Also, costs from equity awards granted to non-executive directors are unlikely to be deductible. The recharge may have unintended consequences on employer tax and/or social insurance withholding requirements.

### **Canada**

Generally, a local tax deduction is not available in connection with share-settled equity compensation awards.

### **China**

A local tax deduction may be available if a recharge agreement is in place. However, foreign exchange restrictions limit the ability to recharge equity compensation costs.

### **Germany**

A local tax deduction may be available if a recharge agreement is in place. In addition, the source of shares underlying the equity compensation awards, and specifically whether they are newly issued, treasury, or purchased from the open market may impact the deductibility of costs.

### **Hong Kong**

A local tax deduction may be available if a recharge agreement is in place.

### **United Kingdom**

The UK tax laws allow a local tax deduction by a UK employer for equity based compensation whether issued by the UK subsidiary or by the parent company of the group. This deduction generally is available regardless of whether a recharge agreement is in place.

---

\*This Appendix contains information of a generalized nature current as of the date of publication. The relevant laws and regulations are complex, change frequently, and may lead to a different result depending on the applicable facts. Readers are strongly encouraged to consult with their legal and tax advisors in connection with any activity

related to the information contained herein.

---

<sup>1</sup> When the company purchases the shares from the open market, the cash cost to the company is the difference between the market price and the exercise price. If treasury stock or newly issued stock is provided, the cost is reflected in the reduction in share price due to dilution.

<sup>2</sup>Incentive stock options must be granted in accordance with a written plan approved by the shareholders. The plan must designate the number of shares to be subject to the options and specify the classes of employees eligible to participate in the plan. The option price must be no less than the market value of the stock at the time of the grant, and it must require exercise within 10 years from the time it was granted. Certain other restrictions may apply.

<sup>3</sup> A deferred tax asset (DTA) is then recorded in order to recognize the future tax benefit that will arise at the exercise of stock options or at the vesting of restricted stock. The DTA serves to reconcile the time and valuation differences between accounting performed at the date of grant and income tax consequences at the date of exercise. If the tax benefit at the time of exercise exceeds the deferred tax asset, the excess benefit is recognized in an Additional Paid-In Capital (APIC) pool. Conversely, if the tax benefit is less than the deferred tax asset, the APIC pool is reduced and the rest is expensed.

<sup>4</sup> This also results an increase in earnings per share because local tax deduction allows for booking of a DTA which provides a tax benefit for financial reporting purposes.

<sup>5</sup> **A note of caution:** whether the strategy is effective also depends on the intercompany pricing relationship between the US parent and the foreign subsidiary. As will be discussed later, if the local subsidiary is a limited risk entity, because the US parent will compensate the local subsidiary and provide a guaranteed level of profit, the cost of the recharges will be ultimately passed back to the US parent via the service fee paid to the subsidiary.

<sup>6</sup> Limited risk distributors or service providers compensated on a cost-plus basis fall into this category.

<sup>7</sup> Full risk principals or partial risk bearing subsidiaries such as licensors fall into this category.

<sup>8</sup> The analysis is also applicable to limited risk distributors.

<sup>9</sup> Tax authorities in many countries take the view that costs related to equity compensation are operating expenses because these are essentially employee compensation costs.

## AUTHORS

---



### Joy Dasgupta

Principal Economist  
Silicon Valley | T: +1 650 833 2000  
joy.dasgupta@dlapiper.com



### Dean Fealk

Partner  
San Francisco | T: +1 415 836 2500  
dean.fealk@dlapiper.com

---