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Stock-Based Compensation in Transfer Pricing: A Mosaic of Rules

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The treatment of stock-based compensation (“SBC”) for financial reporting and tax purposes is complicated. On top of that complexity, how SBC expenses and deductions are treated can vary depending on where a company pays the compensation. Layering on transfer pricing rules and the views and approaches of tax authorities around the world, the treatment of SBC in transfer pricing is often challenging.

SBC is compensation for employees, often in the form of restricted stock units and employee stock options, linked to the value of the employer’s stock. It is typically awarded in addition to cash-based compensation to align employee interests with those of the company’s shareholders, to attract and retain key personnel, and to conserve cash if a company is in the early stages of growth.

The treatment of SBC for financial reporting and tax purposes is complex and can vary significantly by jurisdiction. Consequently, the treatment of SBC in transfer pricing can also be challenging. Questions about the treatment of SBC come up frequently in the context of applying the comparable profits method (“CPM”) per section 1.482-5¹ and its OECD equivalent the transactional net margin method (“TNMM”).²

In applying the CPM/TNMM, two key questions frequently arise related to SBC:

- Should a routine entity whose employees received SBC include that compensation in the entity’s cost base for purposes of determining routine returns?³
- If so, how should this compensation be measured?

The lack of uniformity in local rules and tax authority views on SBC leads to challenges in the application of transfer pricing policies for MNEs and there is no clear roadmap to the “right” answer.

¹ Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).

² SBC issues also commonly arise in the determination of intangible development costs in a cost sharing arrangement. This article does not address this application.

³ A commonly used approach for pricing routine services or tangible goods transactions within a multinational enterprise (“MNE”) is to price the transaction such that the routine entity (service provider, distributor, or manufacturer, as the case may be) is left with a return within a benchmarked range, or a “routine return.” The routine return could be a markup over costs, return on sales, or other measure.

In this article, we first discuss various contexts that require a multinational enterprise (“MNE”) to determine the appropriate treatment of SBC. We then provide some observations on tax authority practice on treatment of SBC in routine return calculations based on our experience and discussions with KPMG global transfer pricing colleagues. An economic analysis of treatment of SBC in routine return calculations is outside the scope of this article, but is equally important to consider and ensure that comparability standards are met.

Background

MNEs need to determine the appropriate treatment of SBC in different contexts: for book accounting at the consolidated level, for book accounting at the local statutory level, for local tax accounting, and for transfer pricing, as discussed below.

- **Book accounting at the consolidated level:** Under both US GAAP and IFRS financial reporting rules, which are widely used accounting standards in MNEs, companies issuing SBC must recognize the compensation as an expense on the income statement, unless it is eligible to be capitalized. SBC is typically recognized over the vesting period and the expense is generally measured based on the fair value of the award at grant. In certain cases, it may have to be remeasured depending on the balance sheet classification of the SBC (liability vs. equity). Accounting standards other than US GAAP or IFRS may be applicable at the consolidated level for MNEs in certain jurisdictions. The specific treatment of SBC under the relevant accounting standard will need to be considered in those cases.
- **Local statutory book accounting:** Local statutory accounting rules may or may not be the same as the parent company rules. Some countries allow companies to choose between two or more accounting standards for their statutory financial statements. For example, several European countries allow companies to choose between IFRS and the local GAAP for their statutory financial accounting. The specific treatment of SBC would be determined based on the applicable accounting standard at the local level. Under certain local accounting standards, SBC cost is not required to be recorded as an expense on the statutory financials of the local entity. In addition, under some local accounting standards, the local book expense may equal the tax deduction amount, while it may be different under other accounting standards.
- **Local tax accounting:** Some jurisdictions allow corporate income tax deductions for SBC granted to employees in their jurisdictions while others do not. SBC granted to foreign employees is generally not deductible in a jurisdiction. For example, a US MNE that grants options to US and foreign employees of the MNE may not deduct the SBC cost for the foreign employees on a US tax return.
 - Among those allowing deductions, some condition the availability of deductions on the existence of formal recharge agreements. A recharge agreement is a written agreement between a parent corporation and its subsidiary under which the subsidiary reimburses the parent for the cost of the SBC granted to the subsidiary’s employees. While countries may have different rules for determining the deductions, under a commonly permissible approach, companies can deduct SBC expense in an amount equal to the stock’s fair market value at vesting (for restricted stock units) or exercise (for stock options) less the price paid by the employee for the share.
 - Some countries permit a deduction for acquired shares but not newly issued shares.
 - Some countries have special rules that condition the deductibility of SBC for corporate income tax purposes on how the SBC income is taxed at the employee level—if the employee income can be taxed at a preferential rate (e.g., as a capital gain), then the employer cannot take a deduction for the SBC expense.

- **Transfer pricing:** The context in which SBC comes up most commonly in transfer pricing is in the determination of the cost base for routine return computations. The question that arises is whether SBC paid to local employees engaged in the controlled transactions should be included in the cost base at all and, if it should be, then what the appropriate measure of SBC cost is—e.g., book expense (per parent GAAP or local GAAP), tax deduction amount, or some other measure.

The treatment of SBC for financial reporting and tax purposes is complex and can vary significantly by jurisdiction. In addition, while most jurisdictions follow the OECD Guidelines, which would require a comparability analysis to determine the appropriate treatment of SBC under the arm's length principle, local country rules and tax authority practices related to the treatment of SBC in transfer pricing may differ by jurisdiction.

Observations on tax authority practice

In 2022 we surveyed 18 KPMG member firms across the North American, EMEA, and Asia-Pacific regions⁴ to gather information on how tax authorities view SBC from a transfer pricing perspective. The discussion below focuses on tax authority practice rather than an economic analysis of treatment of SBC in routine return calculations. The key insights from the survey are presented below.

1. Few jurisdictions surveyed have formal transfer pricing guidance on whether SBC expense should be included in the cost base

The surveyed KPMG member firms nearly all indicated that there is no specific guidance within local transfer pricing regulations on how SBC should be treated. Israel is a notable exception where the inclusion of SBC in the cost base for a cost-plus pricing mechanism was mandated by a High Court decision in 2018 (*Kontera Technologies Ltd. v. TA 3 Assessing Officer*) and the Israeli Tax Authority issued a circular in 2021 to re-affirm this position (*Income Tax Circular No. 1/2021*).⁵

Despite the lack of formal guidance in most jurisdictions, our surveyed member firms indicated that local tax authorities generally expect SBC expenses to be included in the cost base used to calculate the transfer price for a local routine entity's activities so long as the SBC is relevant to the activity and is reflected in the local financial statements. Greater ambiguity exists in places where there are no specific regulations and there is limited practical experience with these matters.

Some jurisdictions, such as Canada and the Netherlands, that do not allow tax deductions for SBC may take an inconsistent approach to SBC depending on whether SBC is included in inbound or outbound charges—while SBC in outbound charges may be expected, SBC in inbound charges may be challenged (i.e., a corporate income tax deduction for these charges may be denied).

⁴ The member firms surveyed were in Australia, Canada, China, Germany, India, Ireland (Republic), Israel, Italy, Japan, Mexico, Netherlands, Romania, Singapore, South Korea, Sweden, Switzerland, the United Kingdom, and the United States.

⁵ KPMG Insights, Israel: Characterization of intragroup recharges for stock-based compensation (Jan. 28, 2021), <https://home.kpmg/us/en/home/insights/2021/01/tmf-israel-characterization-intragroup-recharges-stock-based-compensation.html> (accessed on Jan. 16, 2023).

2. While a common expectation is to follow the “local GAAP” or local statutory financial statement amount for inclusion in the routine return calculation, there is some variation in approach among countries

Again, Israel is a notable exception in formally specifying the measure of SBC to be included in the cost base for a cost-plus pricing mechanism, as per the High Court decision and circular mentioned above. SBC must be included in these charges according to the local GAAP expense (which is largely consistent with IFRS) reported in the audited financial statements. This rule is typically understood as having relevance to any routine activity.

In general, tax authorities expect taxpayers to use the local GAAP (local statutory) financial statement for determining routine returns. Thus, a general expectation would be to include the local GAAP measure of SBC expense when computing routine returns. However, there is some ambiguity and limited practical experience with tax authority views on SBC in certain jurisdictions. Additionally, some tax jurisdictions may accept measures other than the local GAAP amount in the cost base. For example, taxpayers in the UK may choose to use the UK tax deduction amount instead of the UK GAAP amount. Regardless of the SBC cost measure used in the cost base for transfer pricing purposes, companies are generally expected to apply the approach consistently year over year.

Since local GAAP rules may differ across countries, reliance on local GAAP measures for SBC may still lead to differences in treatment of SBC in routine returns across jurisdictions. While our survey did not cover descriptions of local GAAP rules for determination of SBC expense, as noted above, local GAAP rules have numerous variations—they may follow IFRS or US GAAP, some may allow companies to choose between two or more accounting standards for their statutory financial statements, some may not require SBC expense to be recorded on the statutory financials of the local entity, some may have SBC expense equal to the tax deduction or recharge amount but not others. Thus, following local GAAP for SBC cost may still yield different results for routine return computations depending on whether the SBC expense is recorded as zero, fair value as of grant date, or another measure. Where SBC is measured differently for local GAAP and tax accounting purposes, inclusion of the local GAAP expense in the cost base will lead to a mismatch between the cost base used for the routine return and the tax deduction for those costs.

3. The degree of tax authorities’ focus on SBC depends on the jurisdiction and industry

The surveyed KPMG member firms report varying degrees of SBC focus among tax authorities during transfer pricing audits. Given that SBC expense is more widely used in certain industries (e.g., technology and life sciences), tax jurisdictions with heavy concentration of firms in these industries may hone in on SBC more frequently than other tax jurisdictions. For instance, US based technology MNEs often have mature research and development service centers in Ireland, India, and Israel. Accordingly, the local tax authorities in these countries frequently inquire about the inclusion of SBC expense in a routine entity’s cost base during a transfer pricing audit, as confirmed in our survey. The UK HMRC has specifically referred to SBC as an area that has given rise to corrective adjustments as part of the Profit Diversion Compliance Facility.⁶ Other tax jurisdictions also sometimes raise the issue of whether SBC expenses were included in the cost base or in the determination of the transfer price, but do so with lower frequency than the jurisdictions above. Certain other jurisdictions rarely broach the issue of SBC.

⁶ HM Revenue & Customs, Guidance: Profit Diversion Compliance Facility, *Chapter 4 – Content of the Disclosure Report* (specifically, Section “4.2.4.4 Staff profile”) (Jan. 10, 2019), <https://www.gov.uk/government/publications/hmrc-profit-diversion-compliance-facility/profit-diversion-compliance-facility#chapter-4---content-of-the-disclosure-report> (accessed on Jan. 16, 2023).

Conclusion

For transfer pricing practitioners, the inclusion of SBC in the cost base of routine entities is often a challenging topic of discussion. The value and timing of the SBC expense or deduction depends on the accounting and/or tax treatment of SBC, while the treatment of SBC as an expense to be included in the cost base of routine entities depends on the transfer pricing rules and practice of the jurisdiction where employees are granted SBC. Based on KPMG member firm experiences discussed above, jurisdictions differ in their views and approaches on whether and how SBC should be reflected in the cost base of routine entities. These differences, combined with the various other differences in corporate tax determinations around SBC, such as their deductibility, can lead to significant complexity for MNEs and difficulty in application of consistent transfer pricing policies across jurisdictions. Often, MNEs have to develop tailored approaches for different jurisdictions or sets of jurisdictions.

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