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Equity compensation and transfer pricing – emerging cross-border issues

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On 22 June 2020, the US Supreme Court denied review in a closely followed case, *Altera v. Commissioner,* that concerned the validity of the stock-based compensation (SBC) portion of the US cost-sharing regulations that came into effect in 2003. These regulations, and their successors, require that participants in a cost-sharing arrangement include SBC as part of the costs to be shared between the parties. In a unanimous opinion, the US Tax Court concluded that the regulations were invalid, but this decision was reversed by a divided US Court of Appeals for the Ninth Circuit. Because the Supreme Court denied review, the Ninth Circuit decision stands.

There are few issues in international tax over which more ink has been spilled in the US than the *Altera* issue. Accordingly, this article will limit itself to the examination of the cross-border implications of SBC for global transfer pricing policies and the issues likely to arise for multinational enterprises (MNEs) in obtaining bilateral agreements from affected countries.

Background

The proper treatment of SBC for transfer pricing purposes has been a matter of ongoing debate for two decades, mostly in connection with cost-sharing arrangements. For the uninitiated, at a high level a cost-sharing arrangement is an intercompany agreement under which two or more affiliates divide the rights to worldwide intangibles and, in connection with that division, divide intangible development costs in proportion to the benefits expected by each affiliate.

The debate within the transfer pricing community then focused on whether and how SBC should be included in the costs to be shared. It was also initially informed in part by the debate within the financial accounting community concerning whether SBC should be recorded as a financial statement expense or should instead be excluded because it is does not represent an economic cost to the issuer. For US generally accepted accounting principles (GAAP) purposes, this debate was ultimately resolved with the issuance of FASB Statement 123R in 2006, which required companies to include the cost of SBC as an expense in financial statements. In connection with this debate, the

Organisation for Economic Cooperation and Development (OECD) issued a 2004 report on the impact of SBC in transfer pricing that was decidedly noncommittal with respect to whether parties acting at arm's length would share SBC.

Although the OECD issued a report and other tax authorities, such as Australia in 2004, tried to address the transfer pricing consequences of SBC, the issue was much more contentious in the US because of the prevalence of US parented technology companies' use of both cost-sharing to manage their worldwide intellectual property (IP) and stock or options as a significant component of employee compensation. The US Internal Revenue Service (IRS) asserted that the equity-related costs should be shared, claiming that such costs are properly treated as 'costs' under the then-applicable regulation, which would cause the deductions for SBC to be incurred by the foreign participant, which was often subject to no tax or minimal tax.

In response, MNEs made two primary arguments. The first was that SBC should not be treated as a cost at all, echoing the debate in the financial accounting community. The second was that irrespective of whether SBC was a cost, third parties acting at arm's length would not share such costs. Industry participants presented extensive and uncontroverted evidence that unrelated parties would not share such costs and thus should not be shared among members of an MNE group under the arm's length standard. The issue of whether such costs should be included under the arm's length standard was litigated in another case, *Xilinx v. Commissioner*, in which both the Tax Court and Ninth Circuit held that such costs should not be included.

Cross-border issues following BEPS, tax reform and Altera

In 2003, while these early controversies were ongoing, the US government issued additional regulations specifically related to SBC; these would be challenged and ultimately upheld in *Altera*. While the *Altera* litigation was pending, the IRS did not actively pursue other SBC cases, but the Supreme Court's denial of review prompted the IRS to begin issuing proposed assessments. Meanwhile, the international tax environment was also changing in a way that has significant implications for the ongoing treatment of SBC. Beginning in 2013, the OECD began a project intended to address so-called base erosion and profit shifting (BEPS). The BEPS project culminated in a series of reports issued in 2015 that did not materially affect US tax regulations but had a dramatic effect on the non-US tax environment, particularly in Europe. A detailed discussion of BEPS is far beyond the scope of this piece, but several key developments are worth noting. First, the OECD's transfer pricing rules, which are the baseline used by many countries' double tax treaties, were modified to reflect the OECD's increasing emphasis on the location of corporate functions, as opposed to assets or contractual rights, in the allocation of profit between affiliates. Second, the OECD issued new guidelines intended to limit the ability of MNE groups to obtain tax benefits from the use of hybrid entities, namely entities that are regarded as separate in some countries but treated as passthroughs by others.

In response to these changes, a number of US MNEs changed the structure of their cost-sharing arrangements. Historically, many of these arrangements were between US affiliates and affiliates that were treated as separate taxable corporations by the US but not by their local jurisdictions, affiliates not treated as taxable in their local countries, or affiliates located in jurisdictions that imposed no corporate income tax. In response to BEPS, a number of MNEs transferred the interests held by these entities to affiliates in locations also frequently used for regional headquarters, development centres or other operations. Typically, these locations also have a tax treaty with the US.

Importantly, this change means that, unlike in the past, transfer pricing disputes regarding cost-sharing arrangements are now subject to the mutual agreement procedures of double tax treaties between these countries and the US. The availability of treaty relief will likely have significant implications for MNEs following the *Altera* decision. Most US double tax treaties incorporate a provision on related-party transactions similar to Article 9 of the US and OECD Model Tax Treaties, which allow a tax authority to adjust income if transactions between members of an MNE group do not comport with the arm's length standard. Further, the treaties allow affected companies to petition for relief from the relevant countries' competent authorities in order to seek relief from double taxation. Finally, the changes to the US tax system in 2017, including the reduction of the corporate tax rate to a level that is much closer to international norms, means that the stakes regarding which country takes the deductions are far more even. These changes have brought the debate over SBC out of the circumstances of US regulations and into the bilateral or multilateral sphere.

Once an MNE receives a notice of adjustment from the IRS requiring it to include SBC in its pool of costs (which essentially means that it loses a fraction of the deductions in the US), it must typically pursue competent authority relief in order to get a corresponding deduction in the counterparty country. The counterparty country may be reluctant to give a corresponding deduction, particularly given the size of many of the potential adjustments related to SBC, which can cover many years. Under most treaties, the answer will be governed by the arm's length principle. Given that US courts, including the Ninth Circuit, which ultimately ruled in the government's favour in *Altera*, have consistently held that where the arm's length principle applies, SBC is not required to be shared, it seems likely that counterparty countries will make the same arguments that MNEs successfully raised in the pre-*Altera* era of disputes. The Ninth Circuit decision in *Xilinx* may be used to bolster this claim, as the court there pointed to the relevant provision of the US-Ireland treaty in concluding that the arm's length principle should apply and therefore the SBC costs need not be shared.

It is far from clear how these competent authority negotiations will be ultimately resolved. In addition to the core question of whether SBC should be included, there are significant issues regarding the implementation of any SBC inclusion. First, *Altera* may not be the final say in the US. Under US rules, the decision of the Tax Court, which ruled that the regulations were invalid, remains binding precedent in every part of the country except the Ninth Circuit, which means that companies headquartered outside of the West Coast of the US would be expected to win in Tax Court. The government would likely appeal any such ruling, taking the issue to another Court of Appeals and perhaps the Supreme Court, which could complicate bilateral MAP proceedings.

Second, the baseline US rules prescribe the inclusion of costs in an amount equal to the deduction claimed by the US company, which is often the value at exercise, not grant. This makes sense in the context of the US tax system, where the amount and timing of the deduction matches the employees' taxability on the related income. However, most transfer pricing disputes are resolved using financial accounting, which typically values SBC as of the date of grant. It is unlikely that counterparty countries would or should follow US exercise value rules. The US has an election for MNEs with publicly traded stock, which mitigates this difference to some degree, but even that election has requirements, such as acceleration on termination, that treaty partners are likely to find incompatible with their typical application of the arm's length principle.

Third, many MNEs have cost-sharing agreements that provide for a one-time adjustment based on the outcome of *Altera*, which may be difficult to implement in competent authority proceedings with jurisdictions that want to tie the adjustments to the tax years to which the SBC relates. Finally, and perhaps most importantly, there are difficult questions regarding the overall compatibility of the US cost sharing regulations with their OECD counterpart, the Cost Contribution Arrangement rules.

Fourth, SBC also implicates other areas of transfer pricing, such as determining the appropriate price for intragroup services. Hence, countries will not be able to approach the cost-sharing issue in a vacuum.

Finally, and most significantly, while the US rules prescribe the sharing of costs (as the name implies), the OECD rules state that each party must be compensated for the value it contributes, not just the costs that it initially bears. Given this difference, mutual agreement proceedings that are initially limited to SBC may end up resulting in a broader negotiation over the approach charge under conflicting US and OECD rules.

At first glance, this complexity may appear to create an intractable problem that will lead to double taxation with the US government clearly committed, as evidenced by 20 years of litigation, to requiring SBC inclusion and treaty partner governments committed to the arm's length principle resisting such adjustments. However, experience suggests that the competent authorities are quite committed to relieving double taxation, so MNEs can reasonably expect a good faith (even if protracted and contentious) effort to resolve these issues.

Concluding thoughts

To date, the raucous fights over the transfer pricing implications of SBC have been largely confined to the US. However, because of developments in the US and international environments, SBC is quickly becoming a bilateral or multilateral issue. MNEs should carefully consider how the competent authority process may provide an avenue for achieving a result that avoids double taxation and is consistent with the arm's length principle. ■

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