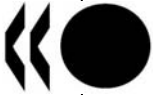


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EMPLOYEE STOCK OPTION PLANS: IMPACT ON TRANSFER PRICING

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PREFACE

This study analyses a number of transfer pricing issues related to stock options. It has been prepared by the OECD Secretariat and benefited from considerable input and detailed discussions from the Delegates to the Working Party No. 6 on the Taxation of Multinational Enterprises of the Committee on Fiscal Affairs. When developing this Study, the OECD Secretariat also received formal and informal input from different sources in the business community. The study is published in the Tax Policy Studies series under the responsibility of the Secretary-General and the views expressed therein are not necessarily those of the Organisation and its members.

After a brief introduction (Section A), the study contains a clarification of the scope of the analysis (Section B). The analysis is limited to transfer pricing issues arising between associated enterprises to the exclusion of Permanent Establishment issues. The scope of the analysis is limited to employee stock option plans, to the exclusion of share-based payments to parties other than employees and of other share-based remuneration mechanisms. The focus in this study is on plans in listed companies. Very importantly, it starts with the premise that employee stock options are remuneration.

The arm's length principle is not relevant when considering whether or not the company issuing the stock option plan should be required to return an amount as taxable income, nor whether this company or the subsidiary that employs the beneficiaries of options should be allowed any tax deduction for stock options, nor does it address the question, where such a deduction is granted, of how it should be computed for domestic tax purposes. These issues are covered by domestic tax rules. It is solely concerned with the question of whether any conditions made or imposed between two associated enterprises in their commercial or financial relations differ from those which would be made between independent enterprises. Three main situations are identified where transfer pricing issues arise.

First situation:

The first situation is where one enterprise grants stock options to employees of an associated enterprise resident in another tax jurisdiction. Two examples are discussed to illustrate this situation, one with respect to a non-dilutive plan according to which employees are granted options to purchase existing shares acquired on the market by the company that issues the options (Section C), and one with respect to a dilutive plan allowing employees to subscribe for new shares (Section D). For both non dilutive and dilutive plans, questions arise as to:

- How the arm's length principle should apply in respect of the commercial and financial relations existing between the company that issues the options and the subsidiaries employing the beneficiaries of the options;
- What transfer pricing methods might be used to determine an arm's length compensation in respect of the commercial and financial relations existing between the issuing company and the subsidiaries employing the beneficiaries of options;
- What factors should be taken into account in applying these methods.

The analysis starts with the description of the controlled transaction(s) under review, identification of the beneficiary(ies) of the transaction and comparability analysis (Sections C.1 and D.1). It is then followed by a discussion of three possible approaches for determining an arm's length compensation (Sections C.2 and D.2):

- An approach based on the fair value of the financial instruments (i.e. the stock options) either by reference to the adjusted market price of comparable options or, where there is no observable market price, based on an option pricing model which would need to be adjusted.
- An approach based on the costs associated with the establishment and provision of the stock option plan.
- An approach based on the value of the stock option plan for the subsidiary that employs the individual beneficiaries of the options.

Each of these approaches has strengths and weaknesses and there remain questions as to the practicalities of these and other possible approaches.

Section C.3 includes some discussion of the particular case of an employee who has been granted stock options and changes employer within the multinational enterprise (hereafter "MNE group") or leaves the MNE group before having exercised them. Sections C.4 and D.3 contain a brief discussion of how domestic tax rules interact with tax treaties (including in respect of relieving double taxation under paragraph 2 of Article 9 or under the Mutual Agreement Procedure in Article 25 of the Model Tax Convention).

Second situation:

The second situation addresses two types of issues that are interrelated: first, the impact of stock options on intra-group transactions other than the provision of a stock option plan where the transfer pricing method to be applied to these other transactions is sensitive to employee remuneration (Section F.) and second the impact of stock options on comparability where employee remuneration of either the tested party or the comparables are materially impacted by stock options. Questions include what comparability adjustments if any are required to account for stock options and how they should be determined (Section G); as well as how domestic rules interact with treaty rules (Section H).

Third situation:

The third situation relates to the impact of stock options on Cost Contribution Arrangements (CCAs). Based on an example, the study contains a discussion of whether and under what circumstances employee stock options must be taken into account in the valuation of the participants' contributions to a CCA, as well as a discussion of the valuation principles that may be applicable and circumstances in which employee stock options may be omitted from the determination (Sections J, K and L).

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EMPLOYEE STOCK OPTION PLANS: IMPACT ON TRANSFER PRICING

Introduction – Scope of the study

A. INTRODUCTION

1. There is a need to examine the impact of employee stock option plans on the commercial and financial relations which exist between members of MNE groups because of the important role they have in the remuneration policies of MNE groups. In MNE groups, stock options (as well as other forms of share-based remuneration) are often issued not by the company employing the beneficiaries but by the listed parent company to the employees of the group's subsidiaries. This may raise a number of transfer pricing issues, including whether under the arm's-length principle there should be a charge for the provision of those options, and if so, how it should be quantified.

2. In addition, domestic tax rules with regard to the assessability and deductibility of amounts associated with stock options provided to employees of the listed parent company and to employees of the group's subsidiaries differ across jurisdictions¹. The issue to be addressed is how domestic tax rules interact with tax treaties in respect of charges received from associated enterprises with regard to the execution of stock option schemes (including in respect of relieving double taxation under paragraph 2 of Article 9 or under the Mutual Agreement Procedure in Article 25) (see Sections C.4 and D.4 below).

3. Another difficulty stems from the lack of uniform accounting treatment of stock option plans. Accounting rules differ from jurisdiction to jurisdiction, and it is not always possible to identify stock options in company accounts as salaries or even as expenses. This lack of uniformity in the accounting treatment of such plans mainly has consequences for ensuring comparability between the controlled and uncontrolled transactions and for the application of transfer pricing methods (see paragraphs 2.28, 2.39-2.40 and 3.40 of the Guidelines) and is liable to introduce certain distortions into transfer pricing:

- Between transactions undertaken by enterprises that operate stock option plans, depending on whether they are booked as expenses or not;

¹ There may be other differences as well. For example, domestic tax rules with regard to transactions by a company in its own stock differ from jurisdiction to jurisdiction.

- And, more generally, between enterprises in comparable lines of business, depending on whether or not their employee remuneration policy includes the granting of stock options.

B SCOPE OF THE STUDY

B.1 Associated enterprises

4. The scope of this study is confined to issues arising under Article 9 (Associated Enterprises) and Article 25 (Mutual Agreement Procedure) of the MTC and does not address issues arising in relation to Article 7 (Business Profits) of the MTC.

B.2 Share-based payments to parties other than employees

5. Entities may issue shares or stock options to pay employees or other parties, e.g. suppliers of professional services. Transactions with parties other than employees include the acquisition of goods or services in exchange for the issue of shares, options, or other equity instruments. Such transactions may in certain cases involve associated enterprises located in different tax jurisdictions and accordingly may pose transfer pricing issues. For instance, it may be the case that services or goods are acquired by an entity of an MNE group in exchange for shares or stock options in the capital of the parent company situated in a different tax jurisdiction. Transactions with parties other than employees however are not in the scope of this study, although it is recognised that they may in certain instances pose similar transfer pricing questions as employee stock option plans.

B.3 Variety of share-based remuneration mechanisms

6. There is a wide variety of share-based remuneration provided to employees. The analysis contained in this study is confined to transfer pricing questions posed by stock option plans.

7. Other forms of share-based remuneration can be classified under two broad categories: those which involve actual stock transactions (e.g. Employee Stock Purchase Plans and Employee Stock Ownership Plans) and those which do not involve actual stock transactions (e.g. Phantom Stocks and Stock Appreciation Rights). Although they may in certain cases pose transfer pricing issues similar to those that arise in relation to stock option plans, they are not addressed here.

B.4 Employee stock option plans

a) General characteristics of employee stock option plans

8. Employee stock option plans are a mechanism to allow employees to acquire shares at favourable conditions, generally subject to certain conditions and restrictions, e.g. the employee must be employed by a member of the MNE group for a certain period of time, there is a minimum period between the moment the option is granted and the moment it is exercised, and/or between the exercise of the option and the sale of the shares that have been subscribed to or acquired, granting and/or vesting of the options under some plans is subject to specified performance and motivation-based criteria being satisfied. The underlying

shares may be listed or not. They may be shares in the employer or shares in another company of the MNE group (usually the parent company).

9. Stock option plans can be classified under two broad categories: “dilutive” stock option plans whereby options are met by allowing employees to subscribe for previously unissued shares in a company (e.g. to a capital increase) on favourable terms, and “non dilutive” stock option plans whereby options are met by providing for the possibility of employees acquiring existing shares on similarly favourable terms.

10. Some stock option plans permit the employee holding the option to elect to receive cash equal to the spread between the strike price and the share price as of the date of exercise, rather than receiving shares in exchange for payment of the strike price. As a practical matter, a stock option plan with such a cash-settlement feature, when the employee elects to receive cash rather than shares, may be difficult to distinguish from a share-based remuneration arrangement involving Phantom Stocks or Stock Appreciation Rights.

11. From an individual taxation perspective, employees benefiting from the plan may or may not benefit from favourable regimes. From a corporation tax perspective, in some cases, a tax deduction may be allowed to either or both the employer of the employee and to the provider of the employee options (usually the parent company), while in other cases no deduction is allowed for corporation tax under domestic rules.

12. Two or more broad types of stock option plans may exist in some MNE groups (e.g. one for "executive employees", another for "general employees", and / or a separate plan for CEOs and other senior management within the MNE group). There may not be a single group-wide plan having common features irrespective of the jurisdiction in which an employee is located, but rather a series of plans within the MNE group with each individual plan tailored to the specific needs of an associated enterprise, or to the regulatory, tax and other legislative requirements of members of the MNE group operating in a particular country.

13. Common forms of structuring (e.g. the use of trusts or Special Purpose Companies to acquire and hold shares until provided to employees) and financing arrangements (e.g. where debt is used to purchase existing shares) can be adopted by MNE groups in relation to their share-based remuneration schemes, including stock option plans.

14. Finally, stock option plans (as well as some other forms of share-based remuneration described in Sub-section B.3 (b) (i) below) might in certain cases have a role as a possible defence to a hostile take-over or as part of a management buy-out.

15. From the standpoint of Article 9 of the MTC, only plans operated by MNE groups and their possible impact on the commercial and financial relations between associated enterprises and the possibilities for relieving double taxation under paragraph 2 of Article 9 and the Mutual Agreement Procedure in Article 25 of the MTC are concerned. Hereafter we shall consider both non-dilutive stock option plans that allow employees to purchase existing shares and dilutive stock option plans that enable them to subscribe to new issues, irrespective of whether they are accompanied by favourable domestic tax provisions or not.

b) Equity ownership vs. Remuneration

16. The analysis in this study starts with the premise that the granting of stock options is an element of remuneration just like performance-related bonuses or benefits in kind, even when stock options are

issued by an entity that is distinct from the employer². In fact in many MNE groups the shares subscribed to or purchased by employees under stock option plans are sold as soon as authorised by the plan and applicable regulations, i.e. employees do not seek to exercise their prerogative as shareholders, apart from benefiting from an increase in value between the strike price paid and the value of the share at the date the option is exercised. Moreover, a stock option is a financial instrument which is valuable and which can be exercised in order to realise such value. Although, upon exercise, the holders of such options may acquire and decide to retain a share in the capital of an enterprise, this investment decision made by each employee is a distinct step from that of the remuneration, one that is occurring at a different point in time and that is of no relevance to the transfer pricing issue under consideration. There might be exceptional cases where this premise would not work, but such cases are not discussed in this study.

c) *Stock options in listed and unlisted companies*

17. The analysis in this study is limited to plans in listed companies. Employee stock option plans in unlisted companies have specific economic characteristics due to the closed character of such companies, which usually limits the liquidity of the shares in the plans, increases the risks and rights inherent in being a shareholder, and raises specific questions as to the valuation of both the options and the shares in question.

18. In particular, in the absence of an open market, stock option plans in unlisted companies are most often dilutive plans whereby employees are granted the right to subscribe to new shares under favourable conditions. Various mechanisms can be implemented to enable employees to re-sell the shares so subscribed, e.g. the issuing company itself may agree to re-purchase its own shares from the employees and subsequently cancel them. The strike price as well as the price at which the shares in question are re-purchased by the company may in some cases be set by reference to other transactions not connected with the stock option plan, where such transactions exist and are appropriate benchmarks (e.g. an increase in share capital or a share transfer involving other shareholders than employees). In addition or alternatively, a pre-determined formula may be provided in the plan, based for instance on a given Price Earning Ratio and / or on the company's net equity at a future date.

19. In comparison to those offered by listed companies, employee stock options in unlisted companies raise additional practical difficulties in relation to valuation and to the application of transfer pricing methodologies:

- Determining the fair market value is more difficult than for listed companies due to the absence of an open market for the underlying stock (see Section C.2 (a));
- Using a recognised option pricing model such as the Black-Scholes formula or binomial method (Cox-Ross-Rubinstein method) is more difficult than for listed companies because these models rely on factors such as Current Stock Price and Stock Volatility which are less directly observable in unlisted than in listed companies (see Section C.2 (a));
- Applying a cost-based approach to stock option plans in unlisted companies raise the same issues as for plans in listed companies, especially those issues related to the definition of costs for dilutive

² This is consistent with the conclusion reached from the perspective of employees' taxation and for the purposes of Article 15 of the MTC, see « Cross-border income tax issues arising from employee stock option plans »: The Committee on Fiscal Affairs agreed that any benefit accruing in relation to the stock-option up to the time when the option is exercised, sold or otherwise alienated should be treated as income from employment to which Article 15 applies.

plans (see Sub-sections C.2 (b) and D.2) ; plus the additional issue of relying on less objective estimates of stock price;

- Finally, risk minimisation strategies for stock in unlisted companies are generally very limited compared to possibilities that might be available for stock in listed companies (see Section C.1 (b) (i)).

These specific issues are not further discussed in this study.

B.5 Situations discussed in this study

20. Three main situations are addressed in this study:

- I. Situation where an enterprise grants stock options to employees of an associated enterprise that is resident in another tax jurisdiction. This will include an examination of whether under the arm's length principle there should be a charge for the provision of those options, and if so, how it should be quantified. Two examples are developed to illustrate this situation: a non-dilutive stock option plan whereby employees are offered the option to buy existing shares (Section C); and a dilutive stock option plan whereby employees are offered an option to subscribe to a share capital increase (Section D).
- II. Situation where the transfer pricing method to be applied is sensitive to employee remuneration and where the employee remuneration of either the tested party or the comparables are materially impacted by stock options.
- III. Situation concerning the impact of employee stock option plans in the context of Cost Contribution Arrangements (CCAs). There is a range of practices among OECD member countries with regard to the recognition and administration of CCAs and this poses questions that go further than just the impact of employee stock options. A brief discussion of these issues is included in this document under Situation III.

21. The distinction between Situation in I on the one hand and Situations II and III on the other hand is an essential one:

- In Situation I, the issue of stock options by one enterprise to the employees of another enterprise (including any management of such a plan) is the subject of the potential intra-group transaction.
- In Situations II and III, in contrast, the transactions analysed are not directly the provision of a stock options plan (and management of the plan), but the possible impact of stock options on the evaluation of other intra-group transactions. The stock option plan is ancillary and analysed only insofar as it impacts materially on the pricing of intra-group transactions in which the beneficiaries of the stock options are directly or indirectly involved.

Situation I: An enterprise grants stock options to employees of an associated enterprise that is resident in another tax jurisdiction.

22. The discussion of Situation I is organised below around two examples:

- A non-dilutive stock option plan, whereby employees of one enterprise are offered options to acquire existing shares of another (associated) enterprise (Section C),
- A dilutive stock option plan, whereby employees of one enterprise are offered options to subscribe new shares of another (associated) enterprise (Section D)

23. These examples are not intended to provide a “one size fits all” solution for all cases, but rather to illustrate how the analysis should be conducted in a typical situation encountered with respect to a stock option plan implemented by an MNE group.

C. TOPCO EXAMPLE: THE “NON-DILUTIVE STOCK OPTION PLAN”

24. THE GROUP is an MNE group whose parent company, TOPCO, is resident in State A and listed on the stock exchange in that State. TOPCO has a large number of subsidiaries in various jurisdictions, SUBCO1, SUBCO2, SUBCO3, etc. It is assumed that all these subsidiaries are ultimately 100% owned by TOPCO. The implementation of an employee stock option plan for employees of THE GROUP is decided by the management of THE GROUP. Accordingly, the subsidiaries include the benefit of a stock option plan in the remuneration package of their employees. The options offered to employees will be options over TOPCO shares, the only company in THE GROUP that is listed on a stock exchange. TOPCO commits itself to provide the necessary options and shares to employees of the subsidiaries who will be designated to benefit from stock options, within certain limits. The plan is approved by TOPCO’s decision-making bodies (the general meeting of shareholders and board of directors). It is then notified to the board of directors and managers of the subsidiaries (SUBCOs), with a mention of the quota of options available to be shared between the employees of each of them. Within this quota, employee stock options are then attributed to employees of the subsidiaries using performance and motivation-based criteria drawn up jointly by THE GROUP’s human resources department and the management and human resources department of the subsidiary.

25. There might be cases where performance or motivation based criteria are also set as conditions for employees to exercise options. In other cases, such criteria are used only to decide who will benefit from the attribution of options and how many options will be attributed to each beneficiary.

26. The plan provides that employees will be granted options in year N which can be exercised in year N+3 if they are still employed in THE GROUP but not necessarily in the same legal entity as when they were granted the options. The options entitle the employees to purchase TOPCO shares at a strike

price that is equal to the shares' market value on the day the options were granted, irrespective of the shares market value at exercise.

27. The example assumes that TOPCO agrees to provide the applicable number of its shares to employees who subsequently exercise their employee stock options, and must therefore be able to access a sufficient number of its shares in order to meet this obligation as and when required (e.g. by purchasing shares on-market). TOPCO may then enter into a variety of hedging strategies to cover the risks linked to any increase or decrease in share value. If necessary, TOPCO also arranges for the liquidity of the shares pursuant to their acquisition by the employees (for instance by re-purchasing the shares from the employee)³.

28. Administrative services for the management of the plan might be provided by TOPCO itself or by a third party (e.g. a bank).

29. In practice, it is found that in some cases, the issuing company may invoice the subsidiaries that employ the beneficiaries of the stock options while in other cases, the issuing company does not charge the subsidiaries for the provision of stock options to their employees. In addition, in those cases where there is a charge, it is found in practice that measurement and settlement dates greatly vary among MNE groups.

30. In this example, it is assumed that the stock options offered to SUBCO's employees are not in the nature of a capital contribution by TOPCO to SUBCO. Further, it is assumed that there is a charge by TOPCO to SUBCO for the provision of the employee stock options plan. We note that under alternative facts, no charge to SUBCO would necessarily be warranted. For example, if TOPCO simply exercises the discretion of a parent to capitalise its affiliate in the form of its choosing, the stock options could be considered a capital contribution.

31. Finally, in the TOPCO example, it is also assumed that upon exercise, employees purchase TOPCO shares directly from TOPCO. There may be other scenarios, for instance whereby TOPCO transfers the shares to SUBCO or to a special purpose vehicle prior to the shares being transferred to the employees. In such instances, the general principles described below would still be applicable, subject to their being adjusted to account for the potential effects of the temporary transfer of shares to SUBCO or to a special purpose vehicle on the assumption of risk and hedging possibilities.

32. This example raises a number of transfer pricing issues, including whether under the arm's-length principle there should be a charge for the provision of those options, and if so, how it should be quantified. The following sections examine:

- How should the arm's length principle apply in respect of the commercial and financial relations existing between TOPCO and SUBCO? (See Section C-1)
- What transfer pricing methods might be used to determine an arm's length compensation in respect of the commercial and financial relations existing between TOPCO and SUBCO? (See Section C-2)
- What happens if an employee changes employer within THE GROUP or leaves THE GROUP after the employee options have been granted and prior to when they can be exercised? (See Section C-3)

³ In theory and notwithstanding legal or managerial restrictions, SUBCO could itself commit to provide these shares to employees who exercise their employee stock options by, for example, purchasing shares on market, without TOPCO's involvement.

- How do domestic tax rules interact with tax treaties (including in respect of relieving double taxation under paragraph 2 of Article 9 or under the Mutual Agreement Procedure in Article 25)? (See Section C-4)

C.1 Applying the arm's length principle: controlled transaction(s) under review, identification of the beneficiary(ies) of the transaction and comparability analysis

33. The arm's length principle of Article 9 of the OECD Model Tax Convention provides that:

“[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.”

34. In order for Article 9 to apply, there must first be “commercial or financial relations” between two associated enterprises. Second, the conditions made or imposed in such commercial or financial relations must not be at arm's length.

35. In the particular example, the commercial or financial relations that exist between TOPCO and SUBCO are those resulting from the establishment by TOPCO of a stock option plan that is made available under certain conditions and limits to SUBCO's employees and agreement by SUBCO to participate in this plan. The transaction that is examined under Article 9 is the transaction taking place between TOPCO and SUBCO. The transactions taking place between TOPCO and/or SUBCO on the one hand and the employees benefiting from the stock option plan on the other hand are not those analysed under Article 9.

36. In general, TOPCO would not grant options (whether over its own shares or over any other instrument) or provide any other type of remuneration to employees of an unrelated party without getting anything in return. Therefore, where TOPCO provides options and shares to employees of SUBCO and does not charge SUBCO for this, or charges less than an arm's-length amount, the second condition for Article 9 to apply would potentially be met as long as SUBCO gets benefits from the option plans⁴.

37. Symmetrically, the conditions for Article 9 to apply would also be met in cases where TOPCO charges SUBCO for an amount exceeding the arm's length compensation (the determination of which is discussed under Section C.2).

a) Controlled transaction under review and identification of the beneficiary(ies) of the transaction(s)

38. Based on an analysis of facts and circumstances, the different types of benefits which might arise from the stock option plan for SUBCO and potentially for other members of the MNE group should be determined.

39. The analysis may reflect that the entity benefiting from TOPCO issuing options is the subsidiary that employs the individuals who benefits from the options. There may also be other cases where the stock option plan is found to benefit to some extent other members of the MNE group (including TOPCO) which are not necessarily the legal employer of the beneficiary of the stock options. This may be the case in particular for stock options granted to employees with geographical or divisional responsibilities that

⁴ Subject to possible characterisation as a capital contribution that is not discussed here.

exceed the limit of the subsidiary that employs them. These matters are discussed in more detail in the discussion on comparability analysis in Section C.1(b) (i) and (iii) below.

40. When employees perform activities that benefit other members of the MNE group beside their employer, they can do so:

- either in the frame of a service activity rendered by their employer to the benefit of those other members of the MNE group,
- or in the frame of a “co-employment situation” whereby in substance they would in fact have more than one employer – even though their employment contracts might be with one entity only.

41. In the first instance, where the employer acts as a service provider to other members of THE GROUP with respect to the activities performed by some employees who benefit from stock options issued by TOPCO, the proper treatment, for transfer pricing purposes, would be to recognise (i) a transaction between TOPCO and the employer with respect to the provision of the stock option plan and (ii) a provision of services by the employer to other members of THE GROUP. This is consistent with the premise in this study that stock options are remuneration for employment services performed by the employees benefiting from the plan. The charge by TOPCO to the employer with respect to stock options granted to these individuals would become part of the cost of rendering services to other members of THE GROUP that might be charged separately. In this case, for the purpose of determining an arm’s length compensation for the provision of a stock option plan by TOPCO, it would not be relevant for TOPCO to be informed of which entity (ies) ultimately benefit from the services of the employees receiving options⁵.

42. A different solution might however be implemented in some cases where the employer is not acting as a service provider to other members of the MNE group with respect to the activities performed by its employees for the benefit of these other members of the MNE group, but where in substance an employee is co-employed by more than one subsidiary. In such cases a split charge by TOPCO in respect of the stock options to the various co-employers might be appropriate. For instance, irrespective of the price per option charged by TOPCO, it may be that the number of options granted to an employee or group of employees needs to be allocated among different members of THE GROUP which in substance are co-employers of the employee(s).

43. This is not an issue peculiar to employee stock options but applies similarly to other forms of remuneration paid to employees whose activities benefit more than one legal entity and there is no need to be prescriptive in this respect, in so far as an arm’s length outcome is achieved, i.e. the subsidiary that legally employs a beneficiary of options who performs an activity for the benefit of other members of the MNE group should not bear more than its fair share of the remuneration package of said individual.

b) Comparability analysis

44. As discussed in Section C(i)(a) of the Guidelines, application of the arm’s length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price, or margin), or that

⁵ A similar reasoning would apply in cases where the employees receiving options are involved in a service activity for third party clients of their employer.

reasonably accurate adjustments can be made to eliminate the effect of such differences. All methods that apply the arm's length principle can be tied to the concept that independent enterprises consider the options available to them and in comparing one option to another they consider any differences between the options that would significantly affect their value and will only enter into a transaction if they see no alternative that is clearly more attractive.

45. Regardless of the transfer pricing methodology used, adjustments must be made to account for differences between the controlled and uncontrolled transactions that would significantly affect the price charged or return required by independent enterprises. In order to establish the degree of actual comparability and then to make appropriate adjustments to establish arm's length conditions (or a range thereof), it is necessary to compare attributes of the transactions or enterprises that would affect conditions in arm's length dealings. These attributes are the five comparability factors described in the Guidelines and discussed in this section.

46. Paragraph 1.39 of the Guidelines acknowledges that associated enterprises are able to make a much greater variety of contracts and arrangements than can unrelated enterprises and may and frequently do enter into arrangements with associated enterprises that are not or are very rarely encountered between independent enterprises. In such cases, practical difficulties arise in applying the arm's length principle. This is because where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, there is little or no direct evidence of what conditions would have been established by independent enterprises (see paragraph 1.10 of the Guidelines). Different approaches for applying the arm's length principle may therefore be needed.

47. The provision of a stock option plan by an enterprise to employees of another enterprise would, as such, be an unlikely transaction between independent enterprises. There are a number of reasons for this. If SUBCO was an independent company, it could consider offering options over its own shares. The feasibility and interest of a stock option plan issued by SUBCO as a stand alone company would depend on a number of factors, one of the most important one being whether or not the options would be issued over shares that are tradable and the value of which is observable. In the situation where SUBCO is a member of an MNE group owned by TOPCO, offering options over TOPCO's shares is convenient because TOPCO shares are tradable and their value is directly observable. In addition, a stock option plan issued by TOPCO provides beneficiaries with an incentive to make decisions that are in the interest of THE GROUP, rather than in the interest of SUBCO only, and therefore favours synergies within the MNE group.

48. This lack of independent comparable transactions is likely to restrict the choice of transfer pricing methodologies for analysing whether the commercial or financial relations between TOPCO and SUBCO arising out of the employee option plan are arm's length. Different approaches than for transactions that exist between independent parties may be needed to achieve the best possible approximation of an arm's length outcome.

49. There are for instance other types of group incentives, e.g. group pension schemes, which may be created, maintained and managed centrally by one entity for the employees of all associated enterprises of a MNE group. There are also examples of third parties issuing financial instruments to employees as part of the remuneration package provided by the employer. For instance, life insurance contracts can be structured, issued, maintained and managed by unrelated insurance companies for the benefit of employees as part of the remuneration package provided by the employer. In such cases, there is a two-step legal relationship:

- The employment agreement between the employer and its employee contains a commitment by the employer to provide certain benefits to its employee as part of his/her remuneration package;

- An agreement between the employer and an insurance company that arranges for the provision of certain benefits to the employee on behalf of the employer.

Although life insurance contracts are not comparable transactions to stock option plans, they usefully illustrate the situation, where the employer, employee and the other party play similar roles with employee stock option plans.

50. Moreover, transactions on options issued by listed companies are common between unrelated parties, and share based payments are also becoming increasingly common, i.e. some companies issue shares or stock options to pay suppliers, such as suppliers of professional services. However, it is unlikely that such transactions on options could be used directly as comparable transactions in assessing the conditions between TOPCO and SUBCO without proper adjustments being made.

51. In analysing Situation I, the starting point of the transfer pricing analysis should be identifying the key economic characteristics of the commercial and financial relations between TOPCO and SUBCO arising out of the employee option plan, having regard to the behaviour of independent enterprises (see paragraphs 1.15-1.16, of the Guidelines) and to the five comparability factors that are described in the 1995 TP Guidelines (see paragraphs 1.15-1.35 of the Guidelines).

i) Characteristics of the stock option plan

52. Employee stock options present a number of specific characteristics that are tailored to each particular plan. First, there are financial characteristics such as underlying stock value, stock volatility, option price and strike price paid by employees, etc. In addition, employee stock options are generally not transferable by employees and become worthless in case the employee leaves the enterprise before a specified date. Vesting conditions differ from one plan to another. Employee stock options also usually have much longer maturity than ordinary traded options. All these characteristics should be adequately taken into account in determining the arm's length compensation of the transaction.

53. Beside characteristics of the options provided, the analysis should also take into account the features of the plan on a wider basis. For example, inter alia it would be relevant to consider characteristics of the particular employee option plan from the perspective of which entities within THE GROUP might obtain direct or indirect benefits from a particular subsidiary participating in TOPCO's employee option plan. A particularly important characteristic in the context of employee option plans will be the presence of any performance or motivation-based criteria which need to be met before employees have the right to exercise their options. These will be important from the perspective of properly analysing the arrangement between TOPCO and SUBCO as the presence of such criteria may provide good indicators of the different types of benefits which might arise from the employee option plan for the various members of THE GROUP and in respect of which entities such benefits might arise (see sub-section C.1 (a)). This will also give useful indications as to what period of employment activity is remunerated through the granting of options (past activity, future performance, or a mixture of both).

54. In the TOPCO example, it is assumed that performance criteria are used to determine the allocation of stock options among employees but do not come into play once options are granted.

ii) Functional analysis

55. Paragraph 1.20 of the 1995 TP Guidelines provides that:

“In dealings between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, comparison of the functions taken on by the parties is necessary. This comparison is based on a functional analysis, which seeks to identify and to compare the economically significant activities and responsibilities undertaken or to be undertaken by the independent and associated enterprises. For this purpose, particular attention should be paid to the structure and organisation of the group. It will also be relevant to determine in what juridical capacity the taxpayer performs its functions”.

Functions

56. In terms of functions, particular attention should be paid to the role of TOPCO’s and SUBCO’s management in the decision making process to establish a stock option plan and then in the decision to attribute options to each particular employee. At one end of the spectrum there are cases in which the decision to establish the plan is made by the parent company which simply notifies to its subsidiaries the name of beneficiaries of options and number of options attributed to each of them, without the subsidiaries being involved at all in the decision making process. This type of situation may provide an indication that the plan is intended to benefit to the parent company rather than to the subsidiaries. At the other end of the spectrum there are cases in which the subsidiaries are informed by their parent company of the possibility to provide options to employees within a certain quota, and are then free to decide who will be the individual beneficiaries among their employees and what number of options will be attributed to each of them. In the TOPCO example, it is assumed that while the implementation of an employee stock option plan and conditions thereof are decided by the management of THE GROUP, employee stock options are attributed to employees of the subsidiaries using performance and motivation-based criteria drawn up jointly by THE GROUP’s human resources department and the management and human resources department of the subsidiary.

57. In addition, administrative and legal services for the management of the plan would generally be provided either by TOPCO itself, or by a third party (e.g. a bank). The nature and extent of such administrative and legal services can significantly differ from one plan to another and may affect the arm’s length compensation of the transaction. Although compensation of legal and administrative services is not specifically discussed in this study, it would need to be appropriately taken into account when determining whether the financial and commercial relations between TOPCO and SUBCO are at arm’s length. In practice, it may be the case that the compensation of administrative and legal services is charged as a separate service fee, or embedded in the compensation charged by TOPCO for the provision of the stock options plan.

Assets

58. As part of the functional analysis it may also be relevant and useful in identifying and comparing the functions performed to consider the assets that are employed or to be employed (see paragraph 1.22 of the 1995 TP Guidelines). In the TOPCO example, assets (if any) needed to establish a risk management strategy could be relevant to the analysis, to the extent such assets determine the ability of TOPCO or SUBCO to implement an efficient risk minimisation strategy.

Risks

59. Any analysis of a stock options related transaction needs to examine whether the arrangement reflects an arm’s length allocation of the risks associated with the possible increase or decrease of the underlying value of the share as well as of the risks associated with the estimated proportion of options that

will be effectively exercised versus those which will be forfeited (e.g. because of employees' departure from the MNE group) or which will not be exercised (e.g. because of a decrease in share value). Risk allocation has a direct effect on the pricing of the transaction; hence the importance of ensuring that the allocation of risks reflects an arm's length behaviour.

60. In practice, there are a myriad of potential allocations of risk to SUBCO, depending on the contractual arrangements between TOPCO and SUBCO and the extent of hedging activities:

- Risk minimisation: The stock options are fully hedged at grant date. This could be achieved, for example, by TOPCO simultaneously purchasing TOPCO shares in the market and buying the same number of put options in TOPCO shares. Alternatively, mirror call options could be purchased in the market. If TOPCO fully hedges the stock options at grant date pursuant to this contractual arrangement, SUBCO would pay the option value to TOPCO at grant date.
- Full risk to SUBCO: The stock options are not hedged at all, and SUBCO bears the risk of increases or decreases in the price of the stock. Under this scenario, TOPCO enters into a contractual agreement with SUBCO at the option grant date effectively requiring SUBCO to cover the cost of the spread between the stock price and the exercise price at exercise date.
- Partial risk to SUBCO: The stock options are partially hedged at grant date. For example, TOPCO might purchase TOPCO shares in the market without corresponding put options. Under this contractual arrangement, SUBCO would pay TOPCO the value of the partial hedge at grant date, and bear the risk associated with the unhedged portion (in this case the risk of a decrease in the stock price).

61. Whether a particular allocation of risk reflects an arm's length behaviour is a factual question and should be examined on a case by case basis. Useful guidance can be found in paragraph 1.27 of the 1995 TP Guidelines:

“An additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of such an allocation in arm's length transactions. In arm's length dealings it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control. For example, suppose that Company A contracts to produce and ship goods to Company B, and the level of production and shipment of goods are to be at the discretion of Company B. In such a case, Company A would be unlikely to agree to take on substantial inventory risk, since it exercises no control over the inventory level while Company B does. Of course, there are many risks, such as general business cycle risks, over which typically neither party has significant control and which at arm's length could therefore be allocated to one or the other party to a transaction. Analysis is required to determine to what extent each party bears such risks in practice. When addressing the issue of the extent to which a party to a transaction bears any currency exchange and/or interest rate risk, it will ordinarily be necessary to consider the extent, if any, to which the taxpayer and/or the MNE group have a business strategy which deals with the minimisation or management of such risks. Hedging arrangements, forward contracts, put and call options, etc, both "on-market" and "off-market", are now in common use. Failure on the part of a taxpayer bearing currency exchange and interest rate risk to address such exposure may arise as a result of a business strategy of the MNE group seeking to hedge its overall exposure to such risks or seeking to hedge only some portion of the group's exposure. This latter practice, if not accounted for appropriately, could lead to significant profits or losses being made which are capable of being sourced in the most advantageous place to the MNE group.”

62. Furthermore, as indicated in paragraph 1.28 of the 1995 TP Guidelines,

“In arm's length dealings, the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties. As such, an analysis of contractual terms should be a part of the functional analysis discussed above. The terms of a transaction may also be found in correspondence/communications between the parties other than a written contract. Where no written terms exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises.”

63. In the TOPCO example, the extent of the risks borne by SUBCO and accordingly the potential need for SUBCO to consider risk minimisation techniques will depend on the contractual arrangement between TOPCO and SUBCO. To the extent that such an arrangement allocates risk to SUBCO, it becomes more relevant for SUBCO to consider risk minimisation techniques.

64. As stated in the Guidelines, “in arm's length dealings it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control”. Although it is not the intention in this study to be prescriptive as to whether or not TOPCO and/or SUBCO would implement a risk minimisation technique, it is necessary to emphasise the importance of ensuring that for transfer pricing purposes the compensation for stock option arrangements within MNE groups should reflect an appropriate allocation of risks among TOPCO and its subsidiaries. This should be done through a proper comparability analysis of the transaction at the time the plan is established, that is, at the time the allocation of risk is determined and the risk minimisation strategy (if any) is adopted. The comparability analysis should be done in accordance with the principles enunciated in the Guidelines and mentioned in the two preceding paragraphs. It is acknowledged 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.

65. In terms of other risks, there is also a need to consider; as for any transfer pricing issue, the wider context in which risks might arise for the participants in the employee stock option plan, in particular, the risks for SUBCO of participating in the employee stock option plan from the perspective of the impact that such participation might have on its business and profitability⁶.

iii) Contractual terms

66. In practice, the contractual arrangement between TOPCO and SUBCO is not necessarily a written agreement. In many cases it is given effect by exchanges of internal documents whereby TOPCO informs each subsidiary of the quota of options that could be attributed to employees and conditions thereof, while each subsidiary informs TOPCO of the identity of the employees who will benefit from the plan and of the number of options attributed to each of them. Conditions surrounding the charge by TOPCO to SUBCO (e.g. how the amount of the charge is determined and at what point in time) are not always documented. Where no written terms exist or where they do not provide sufficient information, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises (see 1995 TP Guidelines, paragraph 1.28).

⁶ A similar concern is expressed under C.1 (b) v) Business strategies, and in section C.2 (iii) when discussing possible transfer pricing methods and an approach based on SUBCO's perspective

67. In arm's length dealings, the key contractual terms of the transaction would presumably be determined upon establishment of the plan, i.e. when SUBCO's and TOPCO's reciprocal commitments are fixed, and in any case no later than grant date. Relevant contractual information at this date should include⁷:

- The purpose and scope of the arrangement for SUBCO's participation in a stock option plan established by TOPCO, a general description of the context and of the reasons for entering into such an arrangement (in particular expected benefits for SUBCO and TOPCO),
- The characteristics of the stock option plan in terms of number of options granted to the employees of the affiliate concerned, beneficiaries, strike price, vesting and other conditions,
- The employment services that are remunerated through the granting of options and in particular which period of services the granting of options related to, consistent with the criteria used for the attribution of options and for vesting conditions;
- The allocation of risks and responsibilities among the parties, and a description of risk minimisation techniques implemented if any,
- A description of the method that will be used to determine the amount charged by TOPCO to the subsidiary, including compensation of risks as appropriate.

68. With respect to the third bullet point, stock option plans in practice can be implemented to reward employment services for SUBCO only and/or for other members of THE GROUP. They can remunerate past performance, future performance or a combination of both. This question was analysed by Working Party No.1 in its document "Cross-border income tax issues arising from employee stock option plans" in which it is noted that:

"In many cases it can be difficult to determine to which services the granting of stock options relates. In some cases, an option may be regarded as rewarding previous performance, in others as an incentive for future performance.

The contractual arrangements would certainly be relevant in that respect. For instance, conditions under which an employee would be prevented from exercising an option unless he remained with the company for a certain period of time would suggest that the option rewards future services. Conversely, the fact that an option is granted to all employees who were employed during a certain period, that options are granted on the basis of past performance, that it is not possible for an employee to lose the benefit of options granted or that the number of options granted depends on the financial results of a previous accounting year could support the opposite view."

69. Given the flexibility surrounding the organisation of stock option plans, it does not seem possible or appropriate to be prescriptive as to what employment services were intended to be remunerated upon establishment of the stock option plan by TOPCO and decision for SUBCO to participate in it. On the other hand, this is key information in many respects:

- to understand SUBCO's benefit in the transaction that takes place with TOPCO;

⁷ This list is intended to provide guidance on key information needed with respect to contractual terms. It is not an exhaustive list of all the documentation requirements of stock-option arrangements for transfer pricing purposes.

- to determine whether SUBCO should bear the whole charge with respect to stock options granted to its employees or should transfer part of the charge to other members of THE GROUP in particular in cases described in sub-sections C.1 (a) above and C.3 (a) below;
- and also to determine how stock options should be taken into account when examining other transactions undertaken by SUBCO (see Situation II).

70. This is one of the reasons why it is suggested in sub-section C.1 (b) (iii) above that the period of employment services the granting of options relates to is part of the contractual terms between TOPCO and SUBCO and that it should be documented upon establishment of the plan.

71. Paragraph 1.37 of the 1995 TP Guidelines indicates that:

“[...] there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. The first circumstance arises where the economic substance of a transaction differs from its form. In such a case the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance. An example of this circumstance would be an investment in an associated enterprise in the form of interest-bearing debt when, at arm's length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. In this case it might be appropriate for a tax administration to characterise the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital. The second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price. An example of this circumstance would be a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research for the term of the contract (as previously indicated in paragraph 1.10). While in this case it may be proper to respect the transaction as a transfer of commercial property, it would nevertheless be appropriate for a tax administration to conform the terms of that transfer in their entirety (and not simply by reference to pricing) to those that might reasonably have been expected had the transfer of property been the subject of a transaction involving independent enterprises. Thus, in the case described above it might be appropriate for the tax administration, for example, to adjust the conditions of the agreement in a commercially rational manner as a continuing research agreement.

72. In the context of the contractual arrangement between TOPCO and SUBCO, it might happen that the economic substance of the transaction differ from its form, e.g. where the identification in the contract of what employment services are remunerated through the granting of stock options is inconsistent with the performance criteria used to attribute options to employees. There might also be cases where contractual terms would allocate to SUBCO most or all of the risks associated with the provision of the stock options, and it would be appropriate to examine whether such an arrangement could be found in similar terms between unrelated parties or whether it differs from what would have been adopted by independent enterprises behaving in a commercially rational manner, thus entailing application of paragraph 1.37 of the 1995 TP Guidelines.

73. Section C2 discusses valuation issues relating to the arm's length charge from TOPCO to SUBCO under the stock option arrangement. Under certain contractual arrangements, the valuation is

undertaken and the charge is incurred at the option's grant date, while under alternative contractual arrangements, no grant-date valuation or charge is required, even though the pricing method (as well as the other contractual terms of the transaction) should have been agreed upon establishment of the plan. For example, if the stock options are not hedged at grant date and SUBCO is obligated to reimburse TOPCO for the spread at exercise, no grant-date valuation or charge is imposed under the terms of the contractual arrangement. Rather, settlement of the contractual obligation is made by SUBCO at exercise date. As stated above, whether such arrangements have economic substance and reflect arm's length behaviour would need to be determined under the transfer pricing analysis.

iv) Economic circumstances

74. As stated in paragraph 1.30 of the 1995 TP Guidelines, "arm's length prices may vary across different markets even for transactions involving the same property or services". In the context of employee stock options, the value of the financial instrument (option) is linked with its value in the market where the stock is listed, and should therefore not be influenced by the location of the subsidiaries.

75. However, when examining the stock option plan in a wider sense, a number of economic factors may mean that the arm's length compensation in respect of the arrangement between TOPCO and one of its subsidiaries may differ from that between TOPCO and another of its subsidiaries, notwithstanding that the same financial instruments (employee stock options) may be provided to the employees of both subsidiaries. In particular, this could be due to differences in the conditions of the market where the subsidiaries operate or to the fact that those conditions affect the subsidiaries differently. Among these different economic circumstances it could be relevant to consider for instance:

- The anticipated rate of exercise of their options by employees, because the value of the stock option plan provided by TOPCO would presumably be higher for a subsidiary with high anticipated exercise rate than for a subsidiary with low anticipated exercise rate;
- The employment market for the subsidiary, e.g. whether there is a high turnover rate and whether stock options are an important element to retain employees in this market, or whether employees in this market traditionally have a low risk appetite and therefore favour cash bonuses over stock option plans,
- Whether the effect of the stock option plans is to bring the remuneration of employees of a given subsidiary at market standards, or well above market;
- The currency exchange rate, because for instance a stock option plan might be a less effective incentive for employees of a subsidiary whose currency is perceived as strong compared to the currency of the issuing company, than for employees of a subsidiary whose currency is perceived as "weak" compared to the currency of the issuing company.

v) Business strategies

76. With respect to business strategies, it will be relevant to consider whether business strategies have been devised by the MNE group or by a member of the group acting separately and the nature and extent of the involvement of other members of the MNE group necessary for the purpose of implementing the business strategy (see paragraph 1.31 of the 1995 TP Guidelines). Paragraph 1.35 of the 1995 TP guidelines states that:

“An additional consideration is whether there is a plausible expectation that following the business strategy will produce a return sufficient to justify its costs within a period of time that would be acceptable in an arm's length arrangement. [...] In the end, however, the most important consideration is whether the strategy in question could plausibly be expected to prove profitable within the foreseeable future (while recognising that the strategy might fail), and that a party operating at arm's length would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions.”

77. Relevant information may include information concerning SUBCO's strategies with respect to the granting of TOPCO's stock options to its employees, especially in cases where the plan provides for massive grant of stock options and/or where SUBCO's involvement in the decision-making process for the attribution of stock options to its own employees is found to be very limited. More generally, of particular relevance in this context will be considerations relating to any performance or motivation-based criteria associated with the employee stock option plan.

78. It would be particularly relevant to consider the effect that participation by SUBCO in TOPCO's employee stock option plan has on its business and on its profitability. Relevant considerations would include examining whether SUBCO's ongoing profitability (whether measured at the level of the entity or at the level of a particular product line or activity) would be so adversely impacted that it was reduced below that which might reasonably be expected to be made by comparable independent enterprises

79. Another area where it might be useful to understand business strategies concerns any risk minimisation technique – or absence thereof – by the party to which the risk is allocated.

C.2 Possible approaches for determining an arm's length compensation

80. The discussion below analyses three approaches to ascertain the extent to which, if any, they might assist in determining whether any charge made by TOPCO to a subsidiary in respect of employee stock options provided by TOPCO to the employees of that subsidiary is arm's length.

- a) An approach based on the fair value of the financial instruments provided (i.e. the employee stock options);
- b) An approach based on the costs associated with the provision of the employee stock option plan; and
- c) An approach based on the value of the employee stock option plan from the perspective of the associated enterprise that employs the beneficiaries of the stock options.

It is also necessary to examine the extent to which these approaches are consistent with the methods described in the 1995 TP Guidelines or need to be adapted.

a) Fair value of the employee stock options

Description of the fair value approach

81. The most direct way to establish whether the conditions made or imposed between associated enterprises are arm's length is to compare the prices charged in controlled transactions undertaken between those enterprises with prices charged in comparable transactions undertaken between independent enterprises (see 1995 TP Guidelines paragraph 2.5). In the context of the transaction undertaken between

TOPCO and SUBCO with respect of the provision of a stock option plan, the Comparable Uncontrolled Price (“CUP”) method would amount to a comparison of the price charged by TOPCO to SUBCO for the provision of the employee stock option plan with the price charged between unrelated parties for a comparable stock option plan in comparable circumstances. Such a direct comparison however is unlikely to be applicable in practice because employee stock option plans are unlikely to be provided between unrelated parties.

82. Considering this practical limitation, an attempt could be made to determine a fair value for the employee stock options by reference to the price of comparable financial instruments on the free market at the date of the grant, that is, by reference to the price of the employee stock options provided by TOPCO if such options were traded on the market in a way similar to how non-employee stock options are traded. To obtain an estimate of the fair market value of the employee stock options, one may begin by considering the value of market-traded options that were issued in relation to the same stock (here, TOPCO’s stock), where such options are effectively traded. Proper adjustments would however be required to take into account the differences between such options and the employee stock options. As such open markets for employee stock options may exist only in rare circumstances, and as it is doubtful that independent parties actually enter into arrangements similar to the one existing between TOPCO and SUBCO, it is acknowledged that applying this approach would, most of the times, yield only an estimate of what these fair market values would have been.

83. When non-employee stock options over TOPCO shares are not traded on markets, this method could not be applicable and a different method for determining a fair market value for the employee stock options could be to use recognised option pricing models that take into account the volatility of the stock price, the present value of the option exercise price and the term of the option. Such models are used by independent parties on the free market and might therefore be utilised in the frame of the Fair Value approach.

84. However, these models would also need to be adjusted to take into account the specific characteristics of employee stock options and to properly address the assumptions underlying the chosen option pricing model which do not hold in the context of employee stock options. In particular, employee stock options are generally not transferable by employees of subsidiaries and are forfeited (and therefore become worthless) in case the employee leaves the enterprise before a specified date. They also usually have much longer maturity than ordinary traded options and have conditions attached to vesting which must be met before the options can be exercised. Developments in recent years by way of enhancements to some of the option pricing models have allowed one or more of the above features to be taken into account, however, the particular option pricing model chosen will need to be checked to establish what features it does take into account and what assumptions may have been made in order to give that method validity in the circumstances of the particular case.

Strengths and weaknesses of the fair value approach

85. The main attraction of the fair value approach is that it represents an attempt to approximate an objective market valuation of the stock options provided, irrespective of TOPCO’s costs and of SUBCO’s benefits to the transaction.

86. One limitation of this approach is that it is looking at the value of each individual option, while the controlled transaction under analysis is the provision of a stock option plan (i.e. a given number of options totalling a certain value). For this approach to be applied properly, it would be necessary to examine not only the price charged by TOPCO for each individual option, but also the proportion of options allocated to SUBCO. It may be that in some instances the price charged for each individual option under a fair value approach is correct, but that the total amount charged to SUBCO for the provision of the

stock option plan is well in excess of what enterprises similar to SUBCO would grant to their employees in similar circumstances or does not adequately take into account what entity(ies) benefit from the provision of the stock option plan (see sub-sections C.1 (a) and C.1 (b) (i) and (iii)). In such circumstances, in accordance with paragraphs 1.36 to 1.41 of the Guidelines, the parameters of the transaction may be adjusted either to ensure that the stock option plans better reflects commercial reality or to appropriately assign stock options to employees of those entities that benefit from the plan. The proportion of options allocated to SUBCO and accordingly the amount charged to it for the provision of the plan will also be affected by the assumptions made with respect to the exercise rate of options by employees, estimated at grant date.

87. 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 its ability to measure and account for such differences.

88. When applying this approach, whether by reference to the price of TOPCO's non employee stock options where they are tradable, or by using an option pricing model, there is an additional concern as to whether adjustments that are reliable enough can be made to account for specific features inherent to employees stock options. As stated in paragraph 1.15 of the 1995 TP Guidelines, "to be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences".

89. Another perceived advantage of the fair value approach is that it presents similarities with the fair market value approach developed for financial accounting purposes (e.g. under IASB or FASB standards) although the latter is not based on OECD comparability standards. However, applying the fair value approach in order to approximate an arm's length compensation for the transaction that takes place between TOPCO and SUBCO would not necessarily amount to applying a fair market value approach for financial accounting purposes. This is because, although there are obvious similarities between both approaches, the objectives of financial reporting are not the same as those when applying Article 9 of the MTC and in particular financial reporting does not look at the commercial or financial relation between TOPCO and SUBCO but rather looks at the consolidated position.

90. Despite this limitation, it is expected that the experience gained of using the fair value approach for financial accounting purposes (in particular on the adaptations needed to reliably apply option pricing models to employee stock options) might provide useful indications for applying the fair value approach in the context of the arm's length principle. In particular, MNE groups might be required in the near future to produce additional information relevant to these methods for non tax reasons and to use these methods to determine an expense charge to be taken into account in the preparation of the group's consolidated financial accounts.

91. In conclusion, the fair value approach might be useful, subject to it not being limited to a review just of the *price* of the financial instruments (options), but also that proper consideration must be given to the *number* of options attributed to SUBCO. In addition, as it is the case for any transfer pricing method, a review of the contractual terms agreed between TOPCO and SUBCO, the functional analysis, economic circumstances and business strategies (see c) below) would be needed. However, there may be difficulties in respect of the reliability of the required comparability adjustments, on which there is currently limited experience.

b) *Cost based approach*

Description of the cost based approach

92. Under a cost based approach, the value of the employee stock option plan provided by TOPCO would be determined on the basis of the total amount of costs of providing these options. In theory, the cost based approach can look at the costs from different perspectives, i.e. either:

- the costs incurred by TOPCO, the supplier of the stock option plan,
- or the costs that would have been incurred by SUBCO to obtain TOPCO shares or options, assuming TOPCO is a third party.

93. Looking at the costs incurred by TOPCO is akin to applying a cost plus method as described in the 1995 TP Guidelines. Under the contractual arrangements assumed in the TOPCO example, the pricing method as well as the other contractual terms would in principle be defined upon establishment of the plan and in any case no later than grant date (see section C.1 (b) (iii) above on contractual terms). Valuation and charge can take place at various points in time between grant date and exercise date. In addition, TOPCO may incur costs to acquire the needed shares (or options) at any moment between grant and exercise, particularly where TOPCO operates a permanent share purchase programme. As a consequence the cost based approach could involve either actual costs as illustrated in Scenarios 1 and 2 below (grant date valuation) and Scenario 3 below (exercise date settlement), or estimated costs as illustrated in Scenario 4 below (grant date valuation but TOPCO does not acquire the financial instruments at grant date).

94. Looking at the costs that would have been incurred by SUBCO to obtain TOPCO shares or options might be seen as a departure from the cost plus method described in the 1995 TP Guidelines, as the cost plus method begins with the costs incurred by the supplier of property or services (see paragraph 2.32 of the Guidelines). In this case, the costs that would have been incurred by SUBCO to obtain TOPCO shares or options provide a proxy for costs that would be incurred by TOPCO. In practice, this would mean taking into account the price of the financial instruments (TOPCO shares or options) on the market at the date agreed for the valuation of the charge irrespective of how and when TOPCO actually acquires the financial instruments(see variation to Scenario 2 below).

95. The four scenarios below illustrate typical applications of the cost based approach that may be found in practice but this is not an exhaustive list. The objective of these scenarios is to identify the costs that would serve as a basis for the charge of the stock option plan by TOPCO under a cost based approach (notwithstanding proper consideration being given to other features of the plan, e.g. the number of options allocated to SUBCO).

96. **Scenario 1:** Valuation and charge at grant date; TOPCO acquires, at grant date, options mirroring its commitments towards SUBCO's employees. In such a case the cost basis could be defined at grant date on the basis of costs incurred by TOPCO, as:

- (i) the acquisition price of options at grant date by TOPCO⁸,

⁸ To the extent that the purchased options do not perfectly hedge the stock option obligations, TOPCO would face an additional cost equal to the present discounted value of the future exercise price of such options

- (ii) plus the costs linked with the provision of services attached to the plan if any (e.g. administrative and legal services, risk management function where appropriate).

97. **Scenario 2:** Valuation and charge at grant date; TOPCO acquires, at grant date, shares in itself to meet its commitments towards SUBCO's employees. In such a case the cost basis could be defined at grant date on the basis of costs incurred by TOPCO as:

- (i) the acquisition price of its own shares by TOPCO on the market at grant date,
- (ii) minus the present discounted value of the contractual strike price to be received by TOPCO from SUBCO's employees,
- (iii) plus the costs linked with the provision of services attached to the plan if any (e.g. administrative and legal services, risk management function where appropriate).

98. A variation to Scenario 2 would be where TOPCO and SUBCO agree that the charge should be based on TOPCO's shares market price at grant date, irrespective of whether or not TOPCO actually acquires all the shares at grant date.

99. **Scenario 3:** Contractual settlement at exercise date: under this scenario although the pricing method would be agreed upon establishment of the plan, the quantification of the price would be based on actual (future) costs and charged to SUBCO at exercise date, once these costs are incurred by TOPCO acquiring shares in itself. The cost basis could be determined at exercise date on the basis of actual costs incurred by TOPCO as:

- (i) the acquisition price of shares by TOPCO (adjusted to take into account funding costs as well as any dividend receivable by TOPCO),
- (ii) minus the contractual strike price to be received by TOPCO from SUBCO's employees, (i.e. the "spread" if acquisition of shares by TOPCO takes place at exercise date)
- (iii) plus the costs linked with the provision of services attached to the plan if any (e.g. administrative and legal services, risk management function where appropriate).

100. Under Scenarios 1 and 2, the charge to SUBCO would be fixed at grant date and would not be revised due to subsequent events (such as an increase or decrease in TOPCO share price, or an actual exercise rate by employees lower or higher than expected). However, there would remain an element of risk for TOPCO since its final actual costs might still be affected by the actual exercise rate of their options by SUBCO's employees. On the other hand, under Scenario 3, the charge to SUBCO would not be fixed until exercise date and SUBCO would bear the risks linked both to the potential increase in TOPCO share price (between the grant date and the date when TOPCO acquires the shares) and to the difference between anticipated and actual exercise rate by employees.

101. **Scenario 4:** Although the valuation is undertaken and the charge is incurred at the option's grant date, TOPCO decides to acquire the needed shares at a future date (no later than exercise date). Compared to Scenarios 1, 2 and 3, Scenario 4 introduces a practical difficulty because actual costs are not yet incurred by TOPCO and are not definitively known at the point in time when valuation and charge to SUBCO take place. The cost basis could be determined based on an estimate at grant date of costs to be incurred by

minus the present discounted value of the contractual strike price to be received by TOPCO from SUBCO's employees from such options.

TOPCO. In order to be able to make this estimate at grant date, TOPCO and SUBCO would need to agree on the key factors that will affect said estimate, and in particular on the date or period over which TOPCO is expected to acquire the needed shares. In practice, it is often the case that TOPCO operates a permanent share purchase programme to cover worldwide employee stock option plans, and it is therefore not always possible to precisely attribute particular shares acquired by TOPCO to a particular beneficiary or even affiliate. It may therefore happen that TOPCO and SUBCO agree, upon establishment of the plan, on a conventional date that will be used to estimate the costs. Such a conventional date might be the grant date, the exercise date, or any other date in between.

102. Scenario 4 introduces a disconnection between what TOPCO actually does (and the costs it actually incurs) to procure the financial instruments (whether it acquires shares or options, and at what date) and what TOPCO or SUBCO could actually have done (and what it would have cost). In this respect it might be seen as a departure from the cost plus approach as described in the 1995 TP Guidelines. This disconnection might be particularly useful in cases where TOPCO operates a global share purchase programme where it is not possible to track which shares are attributed to which employees.

103. There are other possible scenarios and, as already noted, the above list is not intended to be exhaustive. Again, considering the range of contractual situations that may exist in practice and their effect on the valuation undertaken at grant date, whether a particular contractual arrangement reflects an arm's length behaviour is to be examined in view of the facts and circumstances of each case. This is particularly relevant for Scenario 3, in which SUBCO bears the risks associated with the stock options, and for Scenario 4, which involves particularly difficult valuation issues.

104. Whatever the scenario, the costs taken into account in a cost based approach would not necessarily correspond to accounting costs reported by TOPCO. As already discussed, accounting costs / expenses to TOPCO (depending on accounting treatment) could be nil and an approach strictly based on the accounting costs / expenses, the charge to the subsidiaries would then also be nil. This seems initially to be an unsatisfactory outcome since it fails to take account of the fact that an arm's length receiver of a service would pay for that service if it was valuable to it, whatever the accounting cost to the provider.

Effect of the risk allocation and risk minimisation strategy

105. Taking risk allocation and risk minimisation techniques into account in a cost based approach is important as this will directly impact the price of the transaction. This can be illustrated as follows:

- There may be cases where TOPCO and SUBCO agree upon establishment of the plan that SUBCO will be charged on a cost based approach with respect to employee stock options provided by TOPCO to SUBCO's employees, subject to an appropriate risk minimisation technique to be implemented by TOPCO and reflected in the amount charged to SUBCO.
- There may be other cases where TOPCO decides not to implement a risk minimisation technique. This can be a legitimate business decision at the level of TOPCO, however it would be necessary to examine whether SUBCO would have agreed to bear the risk itself, should it be dealing with an unrelated party.
- Finally, TOPCO's hedging position (in relation to the market) does not necessarily match SUBCO's hedging position (in relation to TOPCO). There might be cases where TOPCO does not hedge in relation to the market (with the result that TOPCO's cost is the spread at exercise date) while the contractual arrangement between TOPCO and SUBCO provides for a grant date valuation (see Scenario 4 and variation to Scenario 2 above). There might be other cases where TOPCO may implement a risk minimisation strategy at THE GROUP consolidated level, but under

the contractual arrangement SUBCO will be charged on a cost-based approach without taking into account the effects of such risk minimisation techniques (e.g. SUBCO will pay the spread on exercise). Whether such asymmetric positions reflect arm's length arrangements is a factual question that needs to be examined on a case by case basis.

106. In fact, the risk analysis that is made by TOPCO on a consolidated basis and the decision whether or not to implement a risk minimisation technique does not necessarily give the answer at SUBCO's level and there is a need to consider these issues as if SUBCO was an independent entity dealing at arm's length with TOPCO.

107. One question that arises with the cost based approach is whether a mark-up should be earned by TOPCO and if so on what cost basis. In providing an employee stock option plan, TOPCO provides financial instruments as well as potentially some administrative, legal and risk management services. With respect to the provision of services, it would seem appropriate for TOPCO to earn a reasonable mark-up (provided that these services are rendered in the interest of SUBCO and are subject to proper application of the guidance in Chapter VII of the 1995 TP Guidelines). Regarding the selection of an appropriate arm's length mark-up for services associated with the provision of the plan such as administrative and legal services, it may be possible to identify arm's length comparables by looking for instance at service providers involved in similar transactions or that provide similar financial services.

108. On the other hand, adding a mark-up on the costs associated with the acquisition of TOPCO shares seems questionable. If a mark-up was to be added to the acquisition cost of TOPCO shares, it would be very difficult to find relevant comparables. One possible view is to consider that it may be appropriate for TOPCO to pass on these costs to its affiliates without a mark-up and to apply a mark-up only to the costs incurred by TOPCO in performing associated services if any (see by analogy paragraph 7.36 of the 1995 TP Guidelines).

Strengths and weaknesses of the cost based approach

109. When based on the actual or estimated costs of TOPCO, the cost based approach presents important similarities with the cost plus method described in the 1995 TP Guidelines, mainly because it "begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser" (see paragraph 2.32 of the 1995 TP Guidelines). On the other hand, there might be cases in practice where the cost based approach would be based on share price, i.e. on what it would have cost SUBCO to acquire TOPCO shares or options, rather than on TOPCO's costs. This latter approach would represent a departure from the cost plus method as described in the 1995 TP Guidelines.

110. The cost based approach clearly has the advantage of starting from the familiar basis of objective costs or observable market prices rather than on a pricing model, and therefore would generally require fewer adjustments to account for the specific features of employee stock options.

111. As is the case for the fair value approach, in order for the cost based approach to be applied properly, it would be necessary to examine not only the price charged by TOPCO for each individual option, but also whether the number of options allocated to SUBCO is at arm's length.

112. The analysis should take into account all the comparability factors that affect the transaction, including the benefits received by TOPCO and SUBCO from this employee stock option plan. Otherwise, there may be circumstances where, while the cost based approach may provide a satisfactory outcome from TOPCO's perspective, it would not take into account the perspective of SUBCO in terms of functional

analysis, economic circumstances and business strategies. In these circumstances the provider's costs would have no or an insufficient connection to the value of the stock option plan provided.

113. Finally, under a cost plus method, "the cost plus mark up of the supplier in the controlled transaction should ideally be established by reference to the cost plus mark up that the same supplier earns in comparable uncontrolled transactions. In addition, the cost plus mark up that would have been earned in comparable transactions by an independent enterprise may serve as a guide" (paragraph 2.33 of the 1995 TP Guidelines). In the context of employee stock option plans, it could be argued that the lack of transactions between independent parties that could be compared to the transaction implemented between TOPCO and SUBCO would be a limitation when trying to apply the cost based approach consistently with the cost plus method described in the 1995 TP Guidelines. If a mark-up is to be added to the costs incurred for the provision of services, it should be possible to find acceptable comparables that provide similar services, because administrative and legal services involved in the management of the plan are often outsourced to third parties (banks). However, if a mark-up was to be added to the acquisition cost of TOPCO shares, it would be very difficult to find relevant comparables and one possible view is to consider that it may be appropriate for TOPCO to pass on these costs to its affiliates without a mark-up and to apply a mark-up only to the costs incurred by TOPCO in performing associated services if any.

c) *Third approach: Value of the provision of the stock option plan from the perspective of SUBCO*

114. There is a general principle in the 1995 Transfer Pricing Guidelines that proper regard should be given to the value of the transaction to the recipient and how much an independent enterprise would be prepared to pay for a comparable transaction in comparable circumstances (see paragraphs 1.15 and 1.16 on comparability in general, paragraph 6.14 in the context of pricing intangible property and 7.29 on services). Determination of an arm's length compensation which minimises the risk of double taxation (and therefore the number of potential MAP cases) and less than single taxation requires a two-sided analysis which considers the commercial and financial arrangements between TOPCO and SUBCO from both the perspective of SUBCO and the perspective of TOPCO. While the fair value and cost based approaches start from the perspective of the provider TOPCO, this sub-section discusses how the perspective of SUBCO might be taken into account in determining what an independent party would be willing to pay for the provision of the stock option plan to its employees.

Description of the approach

115. In order to estimate the value of the employee stock option plan from the perspective of SUBCO, an approach based on an estimate of the savings on wages made by SUBCO as a counterpart to the granting of options to its employees could be considered. Although these savings might be valued in some cases, for instance when the employer offers employees the choice between being granted options and receiving a salary bonus, this situation is probably rare in practice. In principle the savings should correspond to a valuation of the option from the perspective of employees that could differ from the market value of the options, since other criteria should be accounted for such as aversion to risk, risks diversification strategy, perception by the employee of his / her still being employed by the enterprise at exercise date, conditions of individual taxation, etc. As a consequence, this approach should not be applied because the employee's perspective of the value of the options is regarded as irrelevant to evaluate the arm's length compensation of a transaction (s)he is not party to. In addition a valuation from the perspective of the employee would be very difficult to achieve and would introduce an undesired level of uncertainty.

116. Another means to estimate the value of the employee stock option plan from the perspective of SUBCO would be to use one of the transfer pricing methods described in the 1995 TP Guidelines that

examines a profit indicator at the level of SUBCO, for instance depending on what method is appropriate in view of SUBCO's activities, the cost plus method (), the transactional net margin method or a profit split method.

117. When applying one of these methods, the transaction between TOPCO and SUBCO with respect to the provision of a stock option plan would not be examined in isolation, but would rather be considered as one of the components of other transactions undertaken by SUBCO in which the employees benefiting from the stock option plans are involved. When examining whether the conditions of such other transactions are at arm's length, an appropriate transfer pricing method would be applied consistently with the 1995 TP Guidelines and taking into account the full remuneration received by SUBCO's employees, including the amount charged by TOPCO with respect to the provision of stock options to these employees.

118. This can be illustrated by assuming SUBCO operates as a distributor and is charged by TOPCO for the provision of stock options to its sale force. When applying a transactional net margin method to SUBCO's distribution activity (assuming this method is found to be the most appropriate in SUBCO's case, the charge made by TOPCO to SUBCO with respect to stock options would be treated as remuneration for SUBCO's sales force. Where SUBCO's net margin so determined is found to be lower than arm's length, this might be an indication, for instance:

- Of a non arm's length transfer price from related party suppliers to SUBCO for the products distributed;
- Or of non arm's length conditions in the provision of stock options by TOPCO to SUBCO's sales force. For instance, it can be the case that the attribution of stock options has been decided as part of a group wide policy without properly taking into account the characteristics of SUBCO's market;
- Or of the fact that part of the stock options attributed to SUBCO's employees in fact do not remunerate an activity performed for the benefit of SUBCO. For instance there may be cases where beside their distribution activities for the benefit of SUBCO, employees also perform group oriented activities and contribute to develop global synergies which do not directly benefit SUBCO and for which SUBCO is not adequately remunerated. A similar concern may arise in some cases with respect to stock options granted to senior executives performing group wide activities, depending on what services are remunerated through the granting of options,
- Or a combination of two or more of the above factors.

Strengths and weaknesses of the approach

119. Compared to the fair value and cost based approaches, this third approach seems more capable of accounting for all the factors affecting the transaction between TOPCO and SUBCO, beyond the characteristics of the financial instruments (stock options). In particular, this approach carefully examines whether it is appropriate from SUBCO's perspective to participate in the stock option plan established by TOPCO at the price charged by TOPCO. By doing so, it is consistent with paragraph 1.16 of the 1995 TP Guidelines that states that "All methods that apply the arm's length principle can be tied to the concept that independent enterprises consider the options available to them and in comparing one option to another they consider any differences between the options that would significantly affect their value".

120. The main difficulty with this approach as illustrated above is that it potentially loses transactional focus and, if applied alone, it will often not be capable of determining by itself the price for the provision

of a stock option plan by TOPCO. This is because under this approach the provision of stock options is not regarded as a transaction in isolation, but rather as one of the components affecting either the gross or the net margin earned by SUBCO on activities in which its employees participate. As a consequence, where the gross or net margin earned by SUBCO on said activities is found to be lower than an arm's length margin, an excessive (higher than arm's length) charge by TOPCO with respect to the provision of stock options will be one of the possible causes to investigate, but not necessarily the only one. There may also be certain circumstances in which it is valid under the 1995 TP guidelines to evaluate a combination of transactions together to determine an arm's length compensation for the provision of stock options (see paragraphs 1.42 to 1.44 of the 1995 TP Guidelines).

121. As already indicated, the different types of benefits which might arise from the stock option plan for SUBCO and potentially for other members of the MNE group should be determined based on an analysis of facts and circumstances. This is true for all the three approaches described in this paper, and would be dealt with when examining the five comparability factors. On the one hand, it could be considered that the third approach puts greater emphasis on these aspects and therefore might be usefully applied in conjunction with a fair value or cost based approach, as a "sanity check" or even in its own right in circumstances when it is appropriate to evaluate a combination of transactions together under the 1995 TP Guidelines. On the other hand, it also could be considered that this approach is not at all appropriate in the context of an evaluation of the TOPCO – SUBCO transaction, in particular because it would permit tax administrations the discretion to determine routinely that a given employee stock option programme is over generous to employees, not well targeted, etc. In addition, the problems posed as possible reasons for using an approach based on the value to SUBCO, for example that options are only partially for work carried out by employees for SUBCO, should be capable of being identified at an earlier stage of analysis (see sub-sections C.1 (a) and C.1 (b) (i) and (iii))and reflected in the attribution of fair value or cost-based figures, partially to SUBCO and partially elsewhere.

d) Preliminary conclusion on approaches

122. When applying the arm's length principle to the transaction between TOPCO and SUBCO with respect to the provision of a stock option plan, the lack of comparable uncontrolled transactions inevitably makes it difficult to directly use the transfer pricing methods described in the 1995 TP Guidelines. The three approaches described in this study represent an attempt to apply the transfer pricing methods described in the 1995 TP Guidelines to the extent possible in the context of stock options and adapt them where needed.

123. The fair value approach is attractive in that it is an attempt to approximate the objective market value of the financial instruments, and in that sense presents similarities with the comparable uncontrolled price method. However, a possible concern is that this approach might present departure from the 1995 TP Guidelines because it does not rely on a comparison with an actual independent transaction and because its reliability would be questionable due to the significance of adjustments needed to make this approach workable. This in fact is a concern wider than for employee stock options and it may be necessary to develop guidance for pricing financial instruments generally in the 1995 TP Guidelines.

124. The cost based approach presents great similarities with the cost plus method of the 1995 TP Guidelines when applied on the basis of costs incurred by TOPCO. A major strength in applying this approach is that it would potentially rely on costs or prices that are observable (either costs incurred by TOPCO or market prices). A question remains as to whether an arm's length mark up based on a comparison of mark up rates earned by independent companies in comparable transactions should be added and if so on what cost basis (full costs including the costs associated with the acquisition of shares or only costs associated with services).

125. In order to properly apply either the fair value or the cost based approach, it would be necessary to examine not only the price charged by TOPCO for each individual option, but also the number of options allocated to SUBCO. When applying one either of these approaches, care should be taken to take into account all the comparability factors that affect the transaction, including the benefits received by TOPCO and SUBCO from this employee stock option plan.

126. The third approach, based on a review of SUBCO's perspective, may provide an answer to this concern. However, because the third approach would not regard the provision of stock options as a transaction in isolation but rather as one of the component of other transactions implemented by SUBCO, it will often be difficult to apply this approach in isolation in order to determine the arm's length compensation to be charged to SUBCO for the provision of the stock option plan by TOPCO. Further, there are difficult and unresolved issues around this approach. On the one hand, it could be considered that this approach might be usefully applied in conjunction with the fair value approach or cost based approach as a "sanity check", or even in its own right in circumstances when it is appropriate to evaluate a combination of transactions together under the 1995 TP Guidelines. On the other hand, it could also be considered that this approach is not valid in the context of the TOPCO – SUBCO transaction, given that it is based on an evaluation of a profit level indicator of SUBCO and gives tax administrations too much discretion to routinely disregard the stock option plan as structured by the taxpayer.

C.3. The particular case of an employee who changes employer within THE GROUP or leaves THE GROUP

a) The case of an employee who changes employer within THE GROUP

127. A particular difficulty arises when an employee is granted options by TOPCO at a time when s/he is employed by a subsidiary SUBCO1⁹, and then becomes an employee of another subsidiary SUBCO2, and is employed by that other subsidiary when s/he exercises the options. The question arises as to how such an event should be reflected in the determination of the arm's length compensation in respect of the commercial and financial relations existing between in the first place TOPCO and SUBCO1 and in the second place between TOPCO and SUBCO2 arising out of the employee option plan established by TOPCO.

128. This question amounts to determining which entity was the beneficiary of the employment services remunerated by the options. As discussed in sub-section C.1 (b) (iii) on contractual terms, stock option plans can be implemented to remunerate past performance, future performance or a combination of both. It was suggested that the identification of which employment services (past, present or future) are remunerated by the granting of stock options should be documented by the taxpayer upon establishment of the plan. Tax administrations, when reviewing the arrangement between TOPCO and SUBCO with respect to the provision of a stock option plan, would follow the taxpayer's documentation, unless one of the circumstances described under paragraph 1.37 of the 1995 TP Guidelines applies, e.g. where the economic substance of a transaction differs from its form, for example where the documented intent appears to be inconsistent with the criteria used for the attribution of options and vesting conditions. Working Party No. 1 has identified a number of factors that are relevant to determine which employment services are remunerated through the granting of stock options. These factors can provide a useful analytical framework for tax administrations when examining whether the documentation provided, including the contractual terms, is consistent with economic reality or when examining cases where the taxpayer has not provided

⁹ A similar difficulty arises in cases where an employee is employed by TOPCO when receiving the options and then moves to a subsidiary SUBCO before exercising the options.

any documentation. Whether or not the event described in the above paragraph would require the charge made by TOPCO to be partially allocated to SUBCO2 and how this allocation should be made would logically follow from this analysis, and in particular from whether options were granted to remunerate future performance that in fact will benefit SUBCO2 once the employee changes employer.

129. Where it appears that stock options were granted for future performance and that accordingly the charge should be allocated between SUBCO1 and SUBCO2, one further question is whether the initial transaction between TOPCO and SUBCO1 should be amended and completed with a new transaction entered into between TOPCO and SUBCO2, or whether the initial transaction between TOPCO and SUBCO1 should remain unaffected, with a new transaction being established between SUBCO1 and SUBCO2 upon the transfer of the employee. Because the terms and conditions of the transaction between TOPCO and SUBCO1 are to be fixed upon establishment of the plan (no later than grant), the view is that in general the proper adjustments should be made between SUBCO1 and SUBCO2, and not between TOPCO and SUBCO1 or SUBCO2.

b) The case of an employee who leaves THE GROUP

130. Where an employee benefiting from stock options leaves THE GROUP at a date after vesting but before exercise, no specific issue should arise for the subsidiary that employed him / her because it can be assumed that all the employment services remunerated through the granting of stock options would have been completed at vesting date.

131. On the other hand, where an employee leaves THE GROUP before vesting and accordingly loses the right to exercise his/her options, SUBCO would potentially bear the risk of being charged by TOPCO at grant for employment services part of which will in fact not be completed by the employee¹⁰. The question arises as to whether an adjustment to the charge made by TOPCO to SUBCO would be necessary to deal with this issue. However the probability that some employees would leave THE GROUP before having completed the employment services remunerated through the options is one of the factors that should be considered when the terms and conditions of the transaction between TOPCO and SUBCO are determined upon establishment of the plan. In most cases, it is likely that this risk will be dealt with through the determination of an expected rate of exercise by SUBCO's employees that will affect the amount charged by TOPCO.

C.4 Interactions with domestic law

132. The arm's length principle does not address the question of whether a tax deduction should be allowed to an enterprise providing employee stock options to employees of its subsidiaries, or to a subsidiary whose employees have received employee stock options from its listed parent company. This is purely a matter of domestic tax policy, not one that is dealt with in tax treaties.

¹⁰ Depending on the agreed pricing method, valuation date and allocation between TOPCO and SUBCO of the risks linked to a difference between actual exercise rate and anticipated exercise rate of options by SUBCO's employees.

133. Domestic tax rules with regard to the assessability and deductibility at the company level of amounts associated with stock options received by employees differ across jurisdictions. A number of questions have been raised, for example:

- a) How domestic tax laws might apply to TOPCO and SUBCO in respect of charges which relate to an employee stock option plan;
- b) Whether and to what extent any double taxation that might arise in the above circumstances might be relieved by making a corresponding adjustment under Art.9(2) of the MTC or under the Mutual Agreement Procedure in Art. 25 of the MTC.

134. Issues around Mutual Agreement Procedures of Article 25 of the MTC are being reviewed by the OECD in the framework of a specific project on improving dispute resolution (information is available on the OECD Internet site www.oecd.org/taxation).

135. The arm's length principle contained in Article 9 provides that associated enterprises should determine their profits as if they were unrelated parties. Profits so determined are then "taxed accordingly". Applied to SUBCO's perspective, Article 9 does not set a rule that any arm's length charge among associated enterprises should be tax deductible if such charge is by nature non tax deductible in the country receiving it. This question arises by analogy with cases where the domestic tax law in SUBCO's country of residence would not allow a tax deduction in respect of certain amounts associated with an employee stock option plan if such a plan was issued by SUBCO itself to its own employees.

136. There are many examples of expenses that are not tax deductible according to applicable domestic rules for reasons that have nothing to do with the arm's length principle. Such expenses do not become tax deductible just because they would be charged by an associated enterprise. For instance, contributions to political parties may not be tax deductible by a taxpayer resident in one country according to the applicable domestic law. Where such contributions are paid by an associated enterprise resident in another tax jurisdiction to the benefit of a taxpayer and subsequently charged to this taxpayer, this would not make the charge tax deductible in the taxpayer's jurisdiction. This is the case for many other items that greatly vary depending on countries' legislation, e.g. some types of overhead expenses (luxury cars, etc).

137. On the other hand, a case where no compensation is paid by SUBCO to TOPCO (or compensation lower than arm's length) might lead the tax administration in the jurisdiction in which TOPCO is resident to make a primary transfer pricing adjustment based on the arm's length compensation in respect of the commercial or financial dealings between TOPCO and SUBCO associated with the employee option plan.

138. For illustration purposes, let us assume that TOPCO's profits are adjusted according to Article 9-1 of the MTC to account for an arm's length compensation for options granted to employees of SUBCO where no such compensation was initially provided. Under Article 9-2, a corresponding adjustment of SUBCO's taxable basis would only be needed if:

- The amount that was added back to TOPCO's profits corresponds to an amount that was included in SUBCO's profits and charged tax in the country of SUBCO;
- Such an adjustment to the amount of the tax charged is "appropriate" and, therefore, reflects the arm's length principle; and
- An arm's length charge for stock options if paid by SUBCO to TOPCO would be deductible under the tax rules of the State of residence of SUBCO.

Thus, whether the resident State of SUBCO would make a corresponding downward adjustment to SUBCO's tax liability depends on the domestic tax treatment of stock options in that State.

139. Let us now consider the opposite case, i.e. where an adjustment is made to SUBCO's profits according to Article 9-1 of the MTC where compensation initially provided by SUBCO is excessive (higher than arm's length). Under Article 9-2, a corresponding adjustment of TOPCO's taxable basis would only be needed if:

- The amount that is added back to SUBCO's profits corresponds to an amount that was included in TOPCO's profits and charged tax in the country of TOPCO and
- Such an adjustment to the amount of the tax charged is "appropriate" and, therefore, reflects the arm's length principle.

Thus, whether the resident State of TOPCO would make a corresponding downward adjustment to TOPCO's tax liability depends on the domestic tax treatment of stock options in that State.

140. In such examples, there would be no "taxation not in accordance with the MTC" and the taxpayer could not access the Mutual Agreement Procedure under Art. 25-1 or 25-2 of the MTC. However, under Article 25-3 of the MTC, it would be open to competent authorities where a similar provision exists under the bilateral treaty to "consult together for the elimination of double taxation in cases not provided for in the Convention". In this context, it may be important to agree on the quantum of stock options to be allocated between TOPCO and SUBCO even where SUBCO's jurisdiction does not permit a tax deduction in relation to stock options.

D. VARIANT TO TOPCO EXAMPLE: DILUTIVE PLANS

141. In this Section we will examine the case of TOPCO issuing a dilutive stock option plan to employees of its subsidiaries. The situation is the same as the one described under Section C, except that the options granted to employees entitle them to subscribe to new shares to be issued by TOPCO (rather than purchase existing shares acquired by TOPCO on the market). The questions discussed in this section are broadly the same as in the case of a non-dilutive stock option plan (Section C), i.e.:

- How should the arm's length principle apply in respect of the commercial and financial relations existing between TOPCO and SUBCO? (Section D-1)?
- What transfer pricing methods might be used to determine an arm's length compensation in respect of the commercial and financial relations existing between TOPCO and SUBCO? (Section D-2)?
- How do domestic tax rules interact with tax treaties (including in respect of relieving double taxation under paragraph 2 of Article 9 or under the Mutual Agreement Procedure in Article 25) (Section D-3)?

D.1 Applying the arm's length principle: controlled transaction(s) under review, identification of the beneficiary(ies) of the transaction and comparability analysis

142. The comments in Section C-1 regarding the description of the controlled transaction(s) are also applicable to dilutive plans, except that instead of acquiring shares in itself on the market, TOPCO issues new shares to the employees in order to meet the options granted. The discussion relating to the

identification of the beneficiary(ies) of the transaction and comparability analysis are similar for dilutive and non dilutive plans.

D.2 Possible approaches for determining an arm's length compensation

143. Three approaches were discussed in Section C-2 with respect to non-dilutive plans:

- a) A fair value approach;
- b) A cost based approach; and
- c) An approach from the perspective of SUBCO.

While the fair value approach and the approach from the perspective of SUBCO would remain unchanged in case of a dilutive plan, the cost based approach deserves specific comments.

144. Whether an approach based on the costs incurred by TOPCO can be applied in the case of a subscription plan is a difficult question. On the one hand it could be argued that the cost based approach is inappropriate for dilutive plans. The main concern in this respect is that in the case of a dilutive plan TOPCO arguably does not bear the costs relevant to determining transfer pricing consequences because these costs are regarded as borne by TOPCO's shareholders. Under such a view, it would be inappropriate if, because TOPCO records no cost, the charge to SUBCO using a cost based approach is nil. There should be equivalence of treatment of dilutive and non-dilutive plans, in the sense that how the plan is structured in this regard should not affect the value of the service provided by TOPCO to SUBCO. In some circumstances, e.g. a dilutive plan where TOPCO recognises no cost, there is arguably insufficient nexus between TOPCO's costs and the value of the provision of the stock option plan for a cost based approach to be used.

145. The view that TOPCO does not bear the costs of employee stock options appears to be based on two lines of argument. First, the financial accounting rules of many countries do not charge employee stock options against reported income, and financial accounting standards can be seen as a proxy for, or at least evidence of, economic cost. Second, as a mathematical matter, the dilution that defines a dilutive plan reduces the relative equity interests of existing shareholders in percentage terms.

146. By contrast, it might be considered under an alternative view that TOPCO does bear the economic cost of the stock options in both dilutive and non-dilutive plans. Such a view would rely on the observation that financial accounting is not necessarily grounded in economic analysis, as evidenced by the shifting international accounting standards on many matters, including the very treatment of employee stock options here at issue. Under such a view, accounting standards are not regarded as a particularly reliable proxy for the kind of economic analysis upon which transfer pricing properly is based. Finally, and most fundamentally, the issuance of employee stock options, apart from the transfer pricing consequences as between TOPCO and SUBCO, has at its root a transaction between SUBCO and its employees, and remuneration, whether in the form of cash, stock options, or other forms of in-kind compensation, should clearly be a cost for transfer pricing purposes.

147. Recognising an economic cost to TOPCO would effectively eliminate the concern regarding the applicability of a cost based approach to dilutive plans. Another possible way of dealing with the concern would be to apply the cost based approach from the perspective of the costs that would be incurred by SUBCO if it acquired TOPCO shares or options on the market. As described in sub-section C.2 (b), this would mean looking at the market price of the financial instruments rather than costs actually incurred by TOPCO. This could be regarded as a departure from the cost plus method described in the 1995 TP

Guidelines and not in accordance with the comparability standard of the 1995 TP Guidelines or the arm's length principle, because it involves speculating on what enterprises that are parties to a dilutive plan would have done to arrive at an arm's length charge. On the other hand, it might present some advantages in practice, as the costs that would have been incurred by SUBCO to obtain TOPCO shares or options serve as a proxy for costs that would be incurred by TOPCO.

148. In fact, it could also be argued that there is merit in trying to adapt the cost based approach described for non dilutive plans to dilutive plans, in particular to try and provide tax neutrality between both mechanisms. For instance, the variation to Scenario 2 described in the cost based approach for non dilutive plans could be adapted for dilutive plans, since it refers to the *market price* rather than the *acquisition price* of TOPCO shares, irrespective of the way TOPCO actually procures the financial instruments (i.e. issue new shares in the case of a dilutive plan). However, since this would represent a departure from the cost plus method described in the 1995 TP Guidelines, it is not an approach acceptable to all.

149. Dilutive plans also raise peculiar issues with respect to risks. In practice, in dilutive plans, financing costs would be nil and TOPCO may be less inclined to implement any risk minimisation strategy before exercise date than in a non dilutive plan. However, it could be considered that from TOPCO's perspective, issuing new shares would represent a hedge¹¹ and that, under a dilutive plan, there would be no rationale in SUBCO being attributed risks in the TOPCO-SUBCO transaction while TOPCO itself does not bear any risk. Accordingly, under this view, there would be some reluctance to apply the cost based approach to dilutive plans if the starting point was the market price of the shares at exercise date or date of issuance by TOPCO (rather than a measure at grant date). A fair value approach at grant date would rather be favoured.

D.3 Applying article 9 of the OECD Model Tax Convention and interactions with domestic law

150. The key difference between dilutive and non-dilutive plans is that in a dilutive plan, the economic costs associated with the stock options are arguably borne by TOPCO's shareholders rather than by TOPCO itself, i.e. under a subscription plan, the entity which meets the legal obligation is arguably not the same as the one incurring the economic costs associated with the plan. It could be argued that this difference provides the basis for differentiating the domestic tax treatment of employee stock option plans. However, this study is not concerned with domestic rules and at the international level there is nothing in Article 9 of the MTC or in its Commentary that would make its application conditional upon a provider incurring the actual expenditure associated with a controlled transaction. What matters for Article 9 to apply is whether the compensation which passes between TOPCO and SUBCO in respect of the employee stock option plan is arm's length, not whether any costs are incurred.

151. In fact, the difference between dilutive and non-dilutive plans affects the financing structure of the plan by TOPCO and the relation between TOPCO and its shareholders. It does not affect the relation between TOPCO and SUBCO. Whether the plan is a dilutive or a non-dilutive plan, SUBCO, through the granting of stock options to its employees, is being provided with an identical economic benefit by an associated enterprise. As a consequence, Article 9 of the MTC applies to the transaction between TOPCO

¹¹ Given that this action gives TOPCO the chief advantages of hedging strategies; namely protection against unpredictable and unquantifiable future cash flow calls, and a volatile profit profile. An alternative argument is that because from the perspective of TOPCO's shareholders, the effect on earnings is the same whether a dilutive or non dilutive plan was used, it follows that the implication for a dilutive plan is that there has been a group decision not to hedge.

and SUBCO irrespective of whether the plan is a dilutive or non dilutive plan and the discussion in section C.4 is found to apply similarly to dilutive plans.

E. PRELIMINARY CONCLUSION TO SITUATION I

152. The implementation of an employee stock option plan by one entity for the benefit of the employees of other entities is a standard transaction in MNE groups, especially where they are listed. The questions discussed in Situation I are:

- How should the arm's length principle apply in respect of the commercial and financial relations existing between TOPCO and SUBCO
- What transfer pricing methods might be used to determine an arm's length compensation in respect of the commercial and financial relations existing between TOPCO and SUBCO
- What happens if an employee changes employer within THE GROUP or leaves THE GROUP after the employee options have been granted and prior to when they can be exercised
- How do domestic tax rules interact with tax treaties (including in respect of relieving double taxation under paragraph 2 of Article 9 or under the Mutual Agreement Procedure in Article 25)

153. In this respect a separate analysis is conducted for non-dilutive plans whereby employees are offered options to purchase existing shares (Section C), and dilutive plans whereby they are offered options to subscribe new shares (Section D).

154. The arm's length principle does not address whether or not TOPCO should be required to return an amount as taxable income, nor whether TOPCO or SUBCO should be allowed any tax deductions associated with employee options, nor does it address the question, where such a deduction is granted, of how it should be computed for domestic tax purposes. It is solely concerned with the question of whether any conditions made or imposed between two associated enterprises in their commercial or financial relations differs from those which would be made between independent enterprises.

155. Irrespective of whether the plan is a dilutive or non-dilutive plan, the arm's length principle of Article 9 of the MTC is found to be applicable to the transaction that takes place between TOPCO and its subsidiaries SUBCOs with respect to the provision of a stock option plan by TOPCO.

156. When applying the arm's length principle to the transaction between TOPCO and SUBCO with respect to the provision of a stock option plan, the lack of comparable uncontrolled transactions inevitably restricts the ability to directly use the transfer pricing methods described in the 1995 TP Guidelines. In trying to determine an arm's length compensation for the transaction(s) between TOPCO and SUBCOs, three possible approaches have been envisaged:

- a) An approach based on the fair value of the financial instruments provided (i.e. the stock options) either by reference to the adjusted market price of comparable options or, where there is no observable market price, by applying an appropriate option pricing model adjusted to account for the specific features attached to options offered to employees.
- b) An approach based on the costs associated with the establishment and provision of the stock option plan.

- c) An approach based on the value of the stock option plan for the subsidiary that employs the individual beneficiaries of the options

157. Each of these approaches has strengths and weaknesses and there remain questions on the validity and practicalities of these approaches, as well as on any other possible approach or combination of approaches.

158. Whatever the approach, the conclusion of this study is that the arm's length pricing method for the transaction or components thereof should be determined upon establishment of the plan and agreement by SUBCO to participate in it (in any case no later than grant date).

159. With respect to dilutive plans, a particular issue arises from the fact that the economic costs associated with the plan are arguably borne by the shareholders of the company issuing the plan rather than by the issuer itself. This line of reasoning could be considered as the basis to differentiate dilutive and non dilutive plans for domestic tax purposes. This view also creates particular difficulties when trying to apply the cost based approach. However, for transfer pricing purposes, there should be neutrality to the extent possible between dilutive and non dilutive plans. This is mainly because the relation between TOPCO and its subsidiaries is not altered by the manner in which the stock option plan is financed. Both dilutive and non dilutive plans lead to the same economic effect, i.e. a transfer of value from TOPCO to the employee that is intrinsically comparable. Moreover, introducing different treatments for transfer pricing purposes depending on what legal scheme is implemented would open significant tax arbitrage opportunities and might not lead to the desired outcome in terms of policy.

160. An important question concerns the interaction of Article 9 with domestic tax rules, in particular in the case where the domestic law in one Contracting State does not allow a tax deduction in respect of certain amounts associated with a stock option plan while domestic law in the other Contracting State requires an amount to be returned as income. In the TOPCO example, TOPCO's profits might be adjusted under Article 9-1 of the MTC to account for an arm's length compensation for options granted to employees of a subsidiary SUBCO if no such compensation (or compensation lower than an arm's length amount) is initially provided. Similarly, SUBCO's profits might be adjusted in case of compensation initially provided to TOPCO higher than arm's length. Under Article 9-2 and/or Article 25 of the MTC, a corresponding adjustment in the other State would only be needed if the primary adjustment corresponds to an amount that has been charged tax in that other State, such an adjustment to the amount of the tax charged is "appropriate" and therefore reflects the arm's length principle, and an arm's length charge for stock options if paid by SUBCO to TOPCO would be deductible under the rules of the State of residence of SUBCO. However, it may be important to agree on the quantum of stock options to be allocated between TOPCO and SUBCO even where SUBCO's jurisdiction does not permit a tax deduction in relation to stock options.

Situation II :

The impact of employee stock options on controlled transactions (other than transactions with respect to stock options) in which the employees benefiting from stock options are involved

and

The impact of employee stock options on comparability analysis when employee remuneration of the tested party or the comparables are materially impacted by stock options.

161. Situation II discusses how employee stock options may affect the application of the arm's length principle to controlled transactions (other than transactions with respect to stock options) involving the employees benefiting from stock options. Based on the premise that employee stock options are remuneration, they should be treated as such when applying any transfer pricing method authorised in the 1995 TP Guidelines. Accordingly, where the transfer pricing method applied is sensitive to employee remuneration, the existence of an employee stock option plan may affect the arm's length price of controlled transactions involving beneficiaries of the option plan.

162. Issues may arise with respect to the definition of costs of the controlled enterprise as well as with the identification of costs incurred by third parties involved in comparable uncontrolled transactions. Both aspects are pretty much inter-related in practice. Section F below focuses on the general question of definition of costs in the transfer pricing methods that are sensitive to remuneration costs and Section G focuses on comparability issues that arise in practice when applying these methods, once it has been established that stock options should be taken into account.

163. It should be noted that in Situation II, unlike Situation I, it does not matter whether the costs of employee stock options are or are not deductible for tax purposes under domestic law, given that the goal is to establish an arm's length price for a transaction other than an employee stock option arrangement. This issue is discussed in more detail in Section H below.

F. THE IMPACT OF STOCK OPTIONS ON CONTROLLED TRANSACTIONS (OTHER THAN TRANSACTIONS WITH RESPECT TO STOCK OPTIONS) IN WHICH THE EMPLOYEES BENEFITING FROM STOCK OPTIONS ARE INVOLVED

164. For the purpose of this discussion, we may consider for illustration purposes:

- (i) the case where controlled transactions are undertaken by a subsidiary (e.g. controlled transactions undertaken by SUBCO) that is charged by its parent company (e.g. TOPCO)

with respect to the provision of a stock option plan for employees of the subsidiary, consistently with the principles elaborated in Situation I of this document.

- (ii) And the case where controlled transactions are undertaken by the company that issues the stock option plan for its own employees (e.g. controlled transactions undertaken by TOPCO)

165. In the first case there will always be an expense recognised in the financial accounts of SUBCO (since SUBCO is charged by TOPCO for the provision of the employee stock options plan¹²). In case (ii) depending on accounting standards in TOPCO's jurisdiction, the expense may or may not be recognised in TOPCO's financial statements.

166. This section reviews the potential impact of employee stock options on controlled transactions remunerated using a cost plus method, a transactional net margin method and a transactional profit split method.

F.1 Transactions remunerated using the cost-plus method

167. The cost plus method involves two issues: the definition of the cost basis and the determination of the mark up to be applied to that cost basis. Both involve comparability issues as discussed in section G. For now it can be noted that the existence of a stock option plan, and the way in which it is treated in the tax and/or financial accounts, can have a direct impact on the cost basis to which any mark up is to be applied if this cost basis is determined by reference to accounting standards. Since the premise in this study is that stock options are remuneration, it follows that the costs of stock options attributed to employees participating in a given controlled transaction should be included in the cost basis irrespective of their accounting treatment, to the extent that other components of said employee remuneration are included in the cost basis at arm's length.

168. In determining the cost basis only the costs of stock options that are attributed to employees involved in the controlled transaction under review and that remunerate the activity of the employees with respect to said transaction should be included in the cost basis. For example, assume SUBCO A is performing a manufacturing activity for associated enterprises, remunerated using a cost plus method, and a service activity for third parties, that is separately charged to these third parties. The costs associated with the provision of stock options to employees involved in the manufacturing activity should in principle be taken into account in the cost basis when applying the cost plus method to this activity, but only to the extent they remunerate the participation of employees to this manufacturing activity. If some employees are involved in both the manufacturing and the service activity, only a fair portion of their remuneration costs and hence of their stock options should be included in the cost basis for application of the cost plus method to the manufacturing activity. Said fair portion should be determined consistently with the determination of the employment services remunerated through the granting of stock options (see discussion in Situation I under sub-section C.1 (b) (iii)). It should identify not only for the right proportion of stock options but also the right period of employment services remunerated through said options.

169. In the example described in the above paragraph, the amount that should be included in SUBCO A's cost basis is the relevant proportion of the amount charged by TOPCO for stock options granted to

¹² This does not address cases where TOPCO does not charge SUBCO or charges less than the arm's length amount for the provision of a stock option plan to SUBCO's employees; nor does it address the case where the provision of the stock option plan is in the nature of a capital contribution by TOPCO to SUBCO.

manufacturing employees, to the extent the amount is determined at arm's length in accordance with the principles set out in Situation I. If the amount charged by TOPCO to SUBCO A is not determined at arm's length, this may affect the price of the transaction that SUBCO A will in turn charge to other members of THE GROUP on a cost plus basis. In particular, if the charge by TOPCO to SUBCO A is not determined upon establishment of the plan or if it does not achieve a fair allocation of risks between TOPCO and SUBCO A, it can adversely impact the arm's length character of the transactions charged by SUBCO A to other associated enterprises.

170. This can be illustrated by another example whereby SUBCO B is a subsidiary of TOPCO that provides trouble-shooting services to related parties on request. TOPCO allocates SUBCO B a number of stock options to be distributed to its employees based on performance criteria decided by SUBCO B.

171. In Year 1 SUBCO C, another subsidiary of TOPCO, requests the assistance of SUBCO B. The trouble-shooting service is a success and the cash remuneration and stock options allocated to the employees of SUBCO B in that year in part reflect that success. Fair value of those options in Year 1 is 200. According to the stock option plan, options attributed to SUBCO B's employees in Year 1 will be exercisable in Year 4. In Year 4 SUBCO D, another subsidiary of TOPCO, requests assistance from SUBCO B. This time the trouble-shooting mission is less successful and that lack of success partly explains the lower number of options allocated to employees of SUBCO B in that year (fair value of options attributed in Year 4 is 100). In Year 4 employees of SUBCO B exercise the options that were attributed to them in Year 1 and make a gain corresponding to the difference between share market price in Year 4 and strike price (spread) amounting to 500.

172. At arm's length, the price charged by SUBCO B to SUBCO C for services rendered in Year 1 should take into account the options attributed to SUBCO B's employees in remuneration of their successful mission in Year 1, irrespective of the fact that TOPCO might actually charge SUBCO B for those options in a subsequent year (depending on the contractual arrangement between TOPCO and SUBCO B). On the other hand the price charged by SUBCO B to SUBCO D for services rendered in Year 4 should not take into account options exercised by SUBCO B's employees in Year 4 because those options do not remunerate services performed in SUBCO D's interest – otherwise the charge to SUBCO D in Year 4 would be based not on the value of services provided to SUBCO D in Year 4, but would include cost of options awarded to them for previous years efforts on behalf of SUBCO C.

	Year 1 – services to SUBCO C	Year 4 – services to SUBCO D
Fair value of options to SUBCO B's employees	200	100
Spread earned by SUBCO B's employees		500
Included in cost base and charged to SUBCO C		???
Included in cost base and charged to SUBCO D		???

173. In the event where the controlled transaction remunerated using a cost plus method is undertaken by TOPCO itself, i.e. by the company issuing the stock options, and TOPCO does not record an amount for the options in its financial accounts, the determination of the amount to be included by TOPCO in the cost basis would raise similar issues as described in sub-sections C.2 (b) and D.2 with respect to the cost-based approach applied in the context of Situation I.

174. Assume for example that TOPCO is providing management services to a number of affiliates in other jurisdictions, charged on a cost plus basis. Assume also that employees involved in this management services activity receive stock options issued by TOPCO for their services, and no cost is recorded by TOPCO in this respect in accordance to accounting standards in TOPCO's jurisdiction. The question arise of whether or not stock options should affect the application of the cost plus method when determining the arm's length compensation for management services provided by TOPCO¹³.

175. In Situation I, issues arise as to whether it is possible to use a cost based approach where there is no cost recorded (see section D.2). However, even if one regards such an approach as not being possible to use, the alternative methods described in the context of Situation I are available, i.e. the fair value approach or the approach from the perspective of SUBCO. In the context of the example described above, the assumption is that the cost plus method has been selected to remunerate a service transaction that is different from the provision of stock options. Three possible solutions might be considered in this case:

- Simply ignore stock options and adopt a strict accounting costs basis. A consequence of this would be that potentially the price of services would be different depending on whether employees providing the services are remunerated in cash or receive stock options and on how said stock options are accounted for in the supplier's accounts. This seems to be an unsatisfactory outcome for transfer pricing purposes.
- Or adjust TOPCO's cost basis to account for stock options granted to employees involved in the management services activity, irrespective of their accounting treatment. The quantum of the adjustment should be determined following principles described in Situation I, i.e. presumably applying either a fair value approach or a cost based approach based on market prices (see section G hereafter).
- Or change the method applied to remunerate the service activity. In particular if no reliable adjustment can be made to the cost plus method, it would follow that this method is in fact not appropriate¹⁴.

176. Whatever the solution, the amount charged by TOPCO in relation for the provision of services should follow the guidance in Chapter VII of the 1995 TP Guidelines (in particular at paragraph 7.29).

F.2 Transactions remunerated using transactional net margin method

177. Where a transactional net margin method is applied to determine the arm's length compensation for a given controlled transaction, remuneration costs will generally have been deducted when determining the net margin. Based on the premise that stock options are part of an enterprise's remuneration costs, the

¹³ It is assumed in the example that the choice of the cost plus method is consistent with the arm's length principle. Furthermore, it may be necessary to consider the extent to which the stock options represent remuneration for shareholder activity (see 1995 TP Guidelines 7.9) but this issue is not discussed here.

¹⁴ As stated in paragraph 2.34 of the 1995 TP Guidelines, "an uncontrolled transaction is comparable to a controlled transaction (i.e. it is a comparable uncontrolled transaction) for purposes of the cost plus method if one of two conditions is met: 1. none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions materially affect the cost plus mark up in the open market; or 2. reasonably accurate adjustments can be made to eliminate the material effects of such differences".

net margin should be set after taking account of the effect of stock options granted to employees for employment services that relate to the controlled transaction.

178. Similar issues to the ones discussed with respect to the cost plus method would apply in the case of a transactional net margin method, i.e. what amount should be taken into account with respect to the provision of employee stock options when computing the net margin of a controlled transaction, as well as the need to take into account the appropriate period of services (see sub-section F.1). In particular, where the transactional net margin method is applied to controlled transactions undertaken by a subsidiary participating in a stock option plan established by its parent company TOPCO, the amount that should be taken into account in the determination of the net margin of the controlled transactions would be the amount charged by TOPCO with respect to stock options granted to employees participating in the controlled transaction so remunerated, to the extent said charge is determined at arm's length. Where the controlled transaction remunerated using a transactional net margin method is undertaken by TOPCO itself, i.e. by the company issuing the stock options, the determination of the amount to be taken into account in the determination of the net margin of the controlled transaction would raise similar issues as the one described in sub-section F.1 with respect to transactions remunerated using the cost plus method.

F.3 Transactions remunerated by a profit split method

179. Profit split methods are potentially very sensitive to remuneration costs. Remuneration costs – and hence employee stock options based on the premise that they are remuneration – can impact upon profit split methods in two ways. Firstly they may impact upon the quantum of the profit to be split (depending on whether the profit to be split is before or after deduction of remuneration costs). In this respect, similar issues arise as the ones discussed in F.1 for the cost plus method and F.2 for the transactional net margin method.

180. Secondly remuneration costs may be a factor in determining how the profits are to be allocated between the parties (as is often the case for instance in global trading cases, see work on the Attribution of Profits to Permanent Establishments). The same principles as for the quantum of the profit to be split would apply to the determination of how employee stock options would affect the allocation key which splits the profits, i.e.:

- Need to take employee stock option remuneration into account in the same way as other components of employee remuneration,
- Need to take into account only stock options attributed in relation to employees participation in the controlled transaction to which a profit split is applied,
- Need to take into account an arm's length value for stock options - whether they are attributed by the company undertaking the controlled transaction under review or by a parent company,
- Need to take into account the appropriate period of services remunerated through the granting of stock options. For instance, if stock options are attributed in remuneration to services performed by employees in Year 1, they should affect the allocation key for that year irrespective of the year during which they are actually charged.

181. In practice, this would require proper identification of what employment services are remunerated through the granting of stock options (nature and period of employee's activity) (see discussion of contractual terms in Situation I, sub-section C.1 (b) (iii)).

G. THE IMPACT OF STOCK OPTIONS ON COMPARABILITY ANALYSIS WHEN EMPLOYEE REMUNERATION OF THE TESTED PARTY OR THE COMPARABLES IS MATERIALLY IMPACTED BY STOCK OPTIONS. DETERMINING A COMPARABILITY ADJUSTMENT

G.1 *Comparability issues raised by employee stock options*

182. The premise is that employee stock options are remuneration in the same way as other types of incentives e.g. cash bonuses or benefits in kind. However due to the lack of uniform accounting treatment of employee stock option plans across jurisdictions, entities are not always required to identify employee stock options in company accounts as salaries or even as expenses. This lack of uniformity in the accounting treatment of such plans mainly has consequences for ensuring comparability between the controlled and uncontrolled transactions and for the application of transfer pricing methodologies (see paragraphs 2.28, 2.39-2.40 and 3.40 of the Guidelines) and is liable to introduce certain distortions into transfer pricing:

- Between transactions undertaken by enterprises that operate stock option plans, depending on whether they are booked as expenses or not;
- And, more generally, between enterprises in comparable lines of business, depending on whether or not their employee remuneration policy includes the granting of stock options.

183. Comparability adjustments in respect of employee stock options may need to be made by taxpayers in determining their transfer pricing of transactions other than those concerning the granting of stock options and by tax administrations in examining whether a taxpayers transfer prices are consistent with the arm's length principle. The comparability adjustments should meet the criteria of economic relevance and accuracy. It is recalled that:

“To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences” (paragraph 1.15 of the 1995 TP Guidelines).

184. Comparability issues in connection with employee stock options will arise each time the transfer pricing method applied is sensitive to employee remuneration, i.e. in particular when the method is a cost plus, a transactional net margin or a profit split method. The following discussion concentrates on comparability issues in applying the cost plus method because it seems that the issues are common to all transfer pricing methods that are sensitive to employee remuneration.

G.2 *Determining a comparability adjustment*

a) Method of adjustment

185. Three types of potential comparability adjustments are discussed below:

- (i) Re-classification of stock options costs for the purposes of costs accounting, when costs are identified but recorded for instance as non operating expenses,
- (ii) Accounting for the value of options granted when an expense is recognised by the controlled enterprise but not by the uncontrolled enterprise.
- (iii) Accounting for the value of options when an expense is recognised by neither the controlled enterprise nor the uncontrolled enterprise.

i) Re-classification of stock options expenses for the purposes of making comparability adjustments.

186. In some cases the costs of granting the options, although recognised as expenses to the profit and loss accounts of the enterprise, need to be re-classified for the purposes of cost accounting for transfer pricing. For instance, it may be the case that option costs are booked below Earnings Before Interest and Tax. They may also be recorded as operating expenses but not as salaries. They may require re-classification as manufacturing costs for the purposes of determining a mark-up on costs, etc. Such re-classification adjustments are particularly difficult to make with respect to third-party comparable data because the necessary information is usually not publicly disclosed.

ii) Taking account of the value of options granted when an expense is recognised by the controlled enterprise but not by the uncontrolled enterprise.

187. Adjustments are even more difficult to perform when options are not reflected in the uncontrolled companies' expenses, for instance, when a comparison is made with a third party that is known to grant options to its employees without these options being reflected in the company's Profit and Loss accounts. The example below considers the comparability issues which arise when applying a cost plus method in situations where one independent comparable issues stock options and another does not. SUBCO M is a subsidiary of TOPCO (see Situation I) that includes in its remuneration policy the attribution of stock options to certain categories of employees. The stock option plan is issued by its parent company TOPCO and invoiced at arm's length by TOPCO to SUBCO M in accordance with the principles set out in Situation I. This charge is recognised as an expense in the profit and loss accounts of SUBCO M.

188. Entity B is an independent enterprise and issues subscription options to its employees on its own shares. Pursuant to the accounting standards applicable in the jurisdiction of B, B does not book an accounting expense in respect of the options. Entity C is also an independent enterprise and does not issue options to its employees but pays them performance-related cash bonuses.

189. SUBCO M, Entity B and Entity C manufacture similar industrial equipment under comparable economic terms for TOPCO situated in a different tax jurisdiction. The equipment manufactured is however not comparable enough to apply the Comparable Uncontrolled Price method. The transfer prices from SUBCO M to TOPCO were set at cost price plus 15 per cent. The sale prices and costs of goods sold by Entity B and Entity C are shown in their respective financial accounts:

	SUBCO M	Entity B	Entity C
Cost of Goods Sold (including wages of manufacturing employees)	800 (including stock options 100)	1,050	1,600 (including cash bonus 215)
Sales price	920 (Cost of Goods Sold plus 15%)	1,320	1,860
Gross profit	120 13%	270 20%	260 14%

190. Companies B & C have been identified as potential comparables of SUBCO M in order to ascertain the arm's length character of the controlled transactions of SUBCO M. This raises the issue of whether any differences in the remuneration policies and accounting standards of B and C from those of SUBCO M would affect their reliability as comparables.

191. In the accounts of SUBCO M, an amount of 100 represents the arm's length compensation paid to TOPCO in respect of the provision of options granted to production personnel, and is treated as a direct production cost in the same way as salaries. This is consistent with the view that options are a component of remuneration, just like a performance-related cash bonus. It therefore seems appropriate to include this amount in SUBCO M's cost basis when SUBCO M is applying a cost plus method to its production activity. The question then is what the appropriate mark-up is: 20% as disclosed by accounts of entity B or 14% as disclosed by accounts of entity C.

192. As regards the accounts of entity B, the question that arises is whether or not a comparability adjustment may be needed in respect of the differences between the accounting treatment of options issued by B and those enjoyed by the employees of SUBCO M. This question can be addressed by examining whether the full value of employees' remuneration has been reflected in the accounts of the controlled entity and in the potential comparables on a consistent basis. In examining Entity B, it can be concluded that the full value of employees' remuneration has not been reflected in Entity B's accounts because no account has been taken of the value of the employee options provided by B to its employees. In contrast, SUBCO M's accounts include the full value of employees' remuneration.

193. An adjustment to the accounting data of B would therefore be necessary for it to be comparable. However, in order to make such an adjustment a considerable amount of further information would need to be known about the remuneration policies of entity B, information which may often not be available in practice. The remuneration policy of SUBCO M is known to reward employees with a cash-to-stock-options ratio of 7:1 (i.e. 700 cash and options with a fair value of 100). Whilst it is reasonable to assume that market forces will dictate that in aggregate (cash plus options) employees of both entities will receive an arm's length amount for the services rendered, different MNE groups may weigh the option to cash components differently. The fact that the value of SUBCO M options make up 12.5% of employee remuneration does not mean that the same is true of entity B. It follows that in the absence of information about the value of options granted to employees of entity B taxpayers and tax administrations will find it very difficult to make reliable adjustments to the cost basis (and hence the mark up) of entity B so that it could be comparable.

194. As regards entity C the question to be answered is what adjustments, if any, need to be made to take account of the fact that SUBCO M issues options to its employees and entity C does not. Following the analysis above it would seem that no adjustment is necessary: in aggregate the remuneration of employees of both SUBCO and entity C is arm's length for the services provided. The accounts of both SUBCO M and entity C reflect the full remuneration packages of their respective employees, so the mark

up achieved by entity C should be applied to the cost pool of SUBCO M (which includes an arm's length compensation for the stock options).

195. The conclusion would seem to be that while it is appropriate to include an arm's length compensation for stock options in the cost basis, in seeking to determine the mark up to be applied to that cost basis an entity which does not issue options to its employees would often be a more reliable comparable than an entity that does issue options whilst failing to account for them¹⁵. Entities which do issue options can be reliable comparables if – and in the context of the current divergence in accounting treatments this is a big 'if' – the value of the options can be readily ascertained, for example if disclosed elsewhere in the accounts with a sufficient level of detail (i.e. breakdown by type of activities or transactions). The current evolution of accounting standards towards greater transparency of financial information should make it possible in most cases to know whether a company offers options to its employees, and what is the market value of options granted¹⁶. Even then, a split by categories of employees or by transactions may generally not be accessible to third parties.

iii) Taking account of the value of stock options granted when no expense is recorded in either the controlled party or the uncontrolled party

196. The example is the same as set out in paragraph 193 except that the controlled entity SUBCO M does not record costs with respect to stock options.

	SUBCO M	Entity B	Entity C
Cost of Goods Sold (including wages of manufacturing employees)	700 (excluding stock options)	1,050	1,600 (including cash bonus 215)
Sales price	805 (Cost of Goods Sold plus 15%)	1,320	1,860
Gross profit	105 13%	270 20%	260 14%

197. A question arises as to whether nevertheless an amount in respect of employee options should be included in the cost basis of SUBCO M for the purpose of applying a cost sensitive method. In light of the discussions above it would seem that an amount in respect of employee options should be included in the cost basis to the extent that the cash element of employee remuneration is included. This is because the value of products manufactured or services performed by an entity (e.g. by SUBCO M and Entity B in the example) is not affected by the accounting treatment of stock options granted to their respective employees. In other words the value added by employees receiving stock options might be affected by the benefits they expect from these options, and therefore by the number of options, vesting conditions, expected increase in underlying stock value etc. but it is unlikely to be materially affected by whether these plans entail costs to be recognised for accounting purposes. The fact that neither SUBCO M nor Entity B expense their employees stock options does not make their cost base necessarily comparable: this would

¹⁵ Because employee stock options are most common in listed companies and in start-ups, it may be the case in practice that many truly independent comparables would not have significant employee stock option plans.

¹⁶ For instance, both IASB Exposure Draft and FASB Statement 123 require detailed information disclosure, which includes vesting conditions, detailed information on how the fair value was measured, option pricing models and inputs to the model, total expense recognized for the period, and details of plan.

only be the case if the remuneration packages of TOPCO and Entity B had similar weightings of cash to options.

198. In this context it is worth recalling that Situation II refers only to transactions other than employee stock options on which the pricing of stock options has a *material* impact on comparability. In cases where the impact of stock options on comparability is not likely to be material it may be enough to compare the cost bases of TOPCO and Entity B without making adjustments for stock options.

b) Period to which the comparability adjustment relates

199. If it is accepted that the valuation of stock options should be determined at the date of grant, the next problem is to determine the period over which it is appropriate to account for that value. Should it be expensed in full in the year of grant, spread over the vesting period, expensed in full in the year in which the options vest, or some other period? As discussed in Situation I section C.1 (iii), the answer to this question depends very much on the facts and objectives of the particular stock option plan. As discussed in Situation I, it should in the first instance be for the taxpayer to determine over which period to expense the option having regard to the objectives and role of the option scheme in the group's remuneration strategy. When reviewing controlled transactions undertaken by taxpayers that are compensated using a transfer pricing method that is sensitive to employee remuneration, taxpayers and tax administrations need to ensure that the costs associated with the stock option plan (whether directly borne by the employer or charged to it by a parent company) are allocated to the year or years in which those options have rewarded or incentivised the employees. More problematically, taxpayers and tax administrations may need to know the expensing periods of the third party comparables. Moreover, in this instance converging accountancy practice may be of limited assistance if it adopts a one size fits all approach; i.e. that either all options are to be expensed in year of grant, or all options are to be expensed over the vesting period, irrespective of whether the options are intended to reward employees for past or future services. It may be however that the use of multiple year data will enable the taxpayer and tax administration to establish an appropriate mark up over costs.

200. Should the taxpayers timing of the expense be adjusted by the tax administration it is important to bear in mind the impact on other methods and comparability. Where a cost plus method is used, for example, only stock options expense that is employee remuneration for the year in which the service is provided is to be included in the cost basis. If the taxpayer has over or under provided for the value of stock options in a particular year that will create an incorrect cost base for charging the services and hence an incorrect price for those services. This creates particular problems when the determination of the charge and settlement for the stock options is deferred until the year of exercise. It can be seen from the example discussed in F.1 that deferring settlement until year four meant that the accounts of SUBCO B (the employer and service provider) did not reflect the cost of the options in the year the service was provided, and that in consequence the full price to SUBCO C would not be known until 3 years after the service was provided. Similar problems occur in any method which does not finalise valuation and make a charge at the date of grant.

201. Let us take the case of employees who receive options from an entity designated as the PROVIDER in respect of activity during year N, which can be exercised in year N + 3. These employees are involved during year N in intra-group industrial sub-contracting work for an affiliate designated as the CLIENT, which is remunerated on a cost-plus basis. Any adjustments to the accounts of the PROVIDER and transfer price calculations for products sold in year N should be made in respect of year N. At arm's length it would seem difficult for the CLIENT to accept that an additional unpredictable amount be invoiced in year N+3 in respect of the price of products purchased in N from the PROVIDER, unless the conditions of this additional invoicing had been specified in year N and the CLIENT had been able to

make adequate provision for it in its accounts in respect of year N. An adjustment made on the basis of the cost or value of the options at the date of grant should make it possible to meet this concern.

202. A specific difficulty relates to the determination of the period of activity remunerated by the options. In the example in G.1, it was assumed that the option expense of 100 recorded by SUBCO M related entirely to services provided employees in year N. However if it transpired that the stock option expense of 100 recorded by SUBCO M above should in fact have been spread over 4 years, then only 25 should have been recorded in the year of review, and the cost basis of SUBCO M reduced by 75. Actually, when options are granted, the period that they remunerate is not always specified. This period may be prior to, or after, the date at which the options are granted; it may be spread over several years. This difficult question was discussed under section C-1 (iii) above.

203. Lastly, it will be noted that if the options are granted by an associated enterprise that is distinct from the employer and invoiced in accordance with the principles set out in Part I, the employer would need to be able to approximate the amount that will be billed to it when it, in turn, calculates the transfer price if such prices are set based on a method that is cost-sensitive. Any material uncertainty about future charges to be received by the employer for activities performed in the past by its employees would complicate or perhaps undermine the subsequent application of transfer pricing methods between the employer and the entities it is dealing with (see discussion under section C-2 (i) above).

H. INTERACTION BETWEEN DOMESTIC RULES AND TAX TREATIES

204. In Situation II, stock options are only a component in the calculation of arm's length compensation in respect of controlled transactions. This raises the question of the characterisation of any payment between associated enterprises which incorporates the cost or value of stock options in accordance with the principles described under Situation II. The same characterisation issue arises if a tax administration makes a primary adjustment to take account of the cost or value of stock options in determining the price of another transaction.

205. If such payments or primary adjustments are characterised as being the price for the provision of stock options themselves, similar issues as those raised in section C.4 above may arise, concerning interactions between domestic tax rules and treaty rules. In particular, arbitrage opportunities (and risks of double taxation) may exist where one jurisdiction offers a tax deduction for stock option costs while the treaty partner regards them as non taxable and non tax deductible items.

206. However, adjustments with respect to stock options under Situation II will generally be regarded as adjustments to the cost of a transaction that is of a different nature, i.e. not the provision of an employee stock option plan. Suppose a taxpayer provides intra-group marketing services remunerated on a cost plus basis, in which the cost of stock options is not included. Where the tax administration auditing the taxpayer makes an adjustment, considering that stock options should be included in the chargeable basis, this adjustment should be regarded as pertaining to the price of a marketing service charge rather than to stock options. The same reasoning would apply to other elements that constitute the cost of a service, e.g. other elements of the remuneration of the provider's employees, depreciation of assets recorded by the service provider, costs of premises, etc.

I. PRELIMINARY CONCLUSION TO SITUATION II

207. The existence of an employee stock option plan, and its accounting treatment, can influence transfer pricing of other transactions when such pricing is sensitive to the employee remuneration of one of

the parties to the transaction and the stock options are material. Accounting standards vary among countries and currently not all countries regard stock options as entailing an expense to the profit and loss accounts of the company that issues them. When conducting comparability analysis it is important to ensure consistency in the cost basis of both the tested entity and the potential comparable, and it may be necessary to make adjustments to the accounts of the either or both entities.

208. Such adjustments, where decided, may pose significant practical difficulties however, notably the difficulty of gaining access to information about the value of the options granted to employees or categories of employees and determining the period to which the adjustments relate. When, in material cases, it is not possible to make satisfactory adjustments, another transfer pricing method that is less sensitive to the employee remuneration may be considered, either in the first instance or as a consistency test.

209. More generally, the issue of comparability adjustments to account for diverging accounting standards leads to the broader question of what accounting standards should be used in comparability analyses and the wider issue of what taxpayers are supposed to do if there is no publicly available data to enable them to determine intra-group transfer prices. These wider issues are addressed in a separate project conducted by the OECD on Comparability issues in general. An invitation to comment and a number of contributions received from the public on that project can be found on the OECD Internet site www.oecd.org/taxation).

Situation III: The impact of stock options on Cost Contribution Arrangements (CCAs)

210. Cost Contribution Arrangements are defined in paragraph 8.3 of the Guidelines:

A CCA is 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.

211. The existence of employee stock option plans poses the question of whether or not stock options should be accounted for in the determination of each participant's contribution to a CCA, especially when a participant contributes by the activity of its employees rather than by cash. In those cases where it is found that stock options should be accounted for, there are further questions as to what valuation principles should be followed.

J. EXAMPLE

212. The application of the arm's length principle to a CCA may be illustrated by considering a CCA entered into between Entity A, resident in State A, and Entity B, resident in State B, to develop a valuable intangible. It is to be assumed that the arrangement does not entail any transfer of an existing intangible. Based on reasonable estimates, the participants project that Entity A will receive 40% and Entity B will receive 60% of the total benefits they expect to obtain from the CCA. Accordingly, Entity A agrees to contribute 40% and Entity B agrees to contribute 60% toward the costs of developing the intangible. If the combined costs incurred by Entities A and B amount to 200X during the relevant tax period, Entity A's share pursuant to the arrangement is 80X (that is, 40% of 200X), and Entity B's share is 120X (that is, 60% of 200X). If States A and B each allow a deduction for research and development costs, then under paragraph 8.23 of the Guidelines, Entity A and Entity B each are entitled to deductions of 80X and 120X, respectively, as if their cost contributions were made outside the CCA to carry on a research and development activity.

213. Suppose that during the relevant tax period, Entities A and B actually incur the 200X of combined costs equally rather than in proportion to their CCA percentages. Because Entity B has actually contributed only 100X, an adjustment would be needed e.g. through Entity B making or imputing a balancing payment of 20X to Entity A for the CCA to satisfy the arm's length principle (see paragraphs 8.18 and 8.26 of the Guidelines). Under paragraph 8.25 of the Guidelines, the balancing payment should be treated for tax purposes as an addition to Entity B's costs and a reimbursement and reduction of Entity A's costs. If State A's and State B's domestic laws treat balancing payments consistently with the corresponding costs, the balancing payment will reduce Entity A's otherwise allowable deductions to 80X and increase Entity B's deductions to 120X.

214. Suppose now that a significant portion of the contributions of Entity A are in the form of making available to the CCA the labour of Entity A employees in developing the intangible. In the event that the employees of Entity A were paid wholly in cash there would be no problem in principle with incorporating

these remuneration costs into the CCA, though questions may arise regarding amounts of remuneration incorporated and the determination of the period to which they relate. Suppose, however, that a significant portion of the remuneration of those employees is in the form of options on Entity A stock, while Entity B does not have a stock option plan. The key issues to consider are:

- Whether or not stock options should be accounted for in determining Entity A's contribution to the CCA and future rights in the intangible developed (Section K below)
- In cases where stock options are accounted for, what should be the valuation principles (Section L).

K. SHOULD STOCK OPTIONS BE INCLUDED IN THE VALUATION OF THE CONTRIBUTIONS OF PARTICIPANTS TO A CCA?

215. In the above example (Section J.), if 30X of the 100X of costs incurred by Entity A were in the form of stock options granted to employees in relation with the intangible development activity but were not taken into account as contributions under the terms of the CCA, then total contributions would be only 170K. Entity A's share pursuant to the arrangement would be 68X (that is, 40% of 170X), and Entity B's share is 102X (that is, 60% of 170X). Because Entity B has actually contributed 100X, Entity B should make a balancing payment of 2X to Entity A. This payment would be 18K less than the payment in the original example because the participants in the second example would not treat the 30X of stock options as an Entity A contribution of which Entity B must bear its 60% share under the CCA (60% of 30X = 18X).

216. There have been active discussions in the business community on this question and some commentators have expressed views against the inclusion of stock options in the valuation of participants' contribution to a CCA. One of their main arguments is that third parties dealing at arm's length do not and would not include stock options in charges made according to CCAs. This argument raises a number of concerns.

217. Application of the arm's length principle is ordinarily based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises (Section C(i)(a) of Chapter I of the 1995 TP Guidelines). In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable. Paragraph 1.39 of the 1995 TP Guidelines acknowledges that associated enterprises are able to make a much greater variety of contracts and arrangements than can unrelated enterprises and may and frequently do enter into arrangements with associated enterprises that are not or are very rarely encountered between independent enterprises. In such cases, practical difficulties arise in applying the arm's length principle. This is because where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, there is little or no direct evidence of what conditions would have been established by independent enterprises (see paragraph 1.10 of the 1995 TP Guidelines).

218. Where independent enterprises do enter into transactions of the type entered into by associated enterprises, it would not be sufficient to simply obtain evidence of cases where independent enterprises did not include employee options in their CCAs. It would also be necessary to examine the economically relevant characteristics of the situations being compared to understand why the independent enterprises did not include employee options in the valuation of participants' contributions to their CCA. Where examination of the surrounding circumstances establishes that the associated enterprises have acted in a way which is comparable to independent enterprises, this would provide very good evidence of arm's

length dealings – irrespective of whether the independent enterprises have included or excluded employee options from the valuation of the contributions of a participant to the CCA.

219. On the other hand, where examination of the surrounding circumstances establishes that the associated enterprises have acted in a way which is not comparable to independent enterprises (i.e. having regard to the available evidence of what conditions would have been established between independent enterprises), then regard should be had to the guidance in paragraphs 1.40, 1.39 and 1.10 of the Guidelines in order to determine what behaviour might reasonably be expected of independent enterprises acting independently in circumstances economically consistent with the conditions established between the associated enterprises.

220. One possible reason for participants' decision not to include stock options in their contribution to a CCA is the failure of accounting standards to reflect the stock options as costs. Such behaviour might change when accounting standards change, possibly suggesting that this explanation for the non-inclusion is inadequate as a transfer pricing analysis because it relies upon changeable accounting standards. However, some commentators believe that the third-party non-inclusion behaviour should be taken at face value without regard to the underlying causes. These commentators suggest that although it may be commercially rational to include stock options in CCA contributions, and although the failure of third parties to do so as a result of accounting standards may reflect a failure of the market to account properly for stock options, non-inclusion nevertheless would be consistent with transfer pricing principles because it properly reflects the manner in which unrelated third parties act in the market. Under such a view, if, upon a change in accounting standards, CCA participants begin to adopt commercially rational behaviour by taking account of stock options, the change would reflect a correction of the current market failure by augmenting the amount and accuracy of the information provided to the market in the form of financial accounting.

221. Another possible reason for excluding stock option costs from participants' contributions to a CCA may be a perceived difficulty in accounting for options. Some commentators have suggested that, similar to a failure to include based on accounting standards, this is a valid explanation for non-inclusion from a transfer pricing perspective because it reflects the manner in which unrelated third parties act in the market. Under new accounting standards, the perception of difficulty may be diminished and may result in inclusion of stock option costs. As with the discussion of accounting standards, other commentators have suggested that difficulty or perceived difficulty is not a proper basis for exclusion because it effectively relies on extraneous non-economic factors rather than a proper transfer pricing analysis.

222. There may also be cases in which third parties fail to include stock options, but have an economic relationship that is in fact very different from the economic relationship between the participants in a CCA. Failure to include stock options under these circumstances does not necessarily imply that parties at arm's length would not take stock options into account in the context of an arrangement similar to a CCA.

223. Other possible reasons why arm's length participants to CCAs do not specifically include options in CCAs, may be that they are implicitly considered into the overall agreement, or that there are natural set-offs. There may be cases where both parties to the CCA grant proportionately similar amounts of stock options to their own employees and could therefore agree to exclude stock options without making the arrangement unbalanced from their perspective, or cases where the expected effect of stock options on the balance of a CCA would not be material. So, for example, if an analysis of the actions of particular independent enterprises showed that stock option costs were left out of the agreement because the aggregate value of the options granted to their respective employees were about the same, then it might also be appropriate for associated enterprises to leave the options out of account when the aggregate value of options granted to their respective employees were about the same (see 1.60-1.64 1995 TP Guidelines on intentional set offs). Where on the other hand the aggregate value of options granted to employees of

one associated enterprise were materially different to aggregate value of options granted to the other associated enterprise then it would not necessarily be appropriate to leave the stock options out of account.

224. Another possible reason that is often put forward is that unrelated parties would not be willing to account for stock options issued by each other because this would be a too unpredictable amount. This is potentially an issue when settlement is at exercise – depending on the facts and circumstances of each particular case - but it is not *necessarily* an argument against the inclusion of stock options per se. Employers may decide whether or not to issue employee stock options in the first place and potentially to assume the risks linked to the issue of stock options, based on considerations that relate both to their remuneration policy and to their internal appreciation of the evolution of the options and shares granted to their employees. The question of whether other companies participating in a CCA with the employer would be willing at arm's length to bear such risks is a different one and is a factual question that should be examined on a case by case basis. In the absence of strong factual evidence, it is difficult to respond to what unrelated parties actually do. It is only possible to hypothesise the behaviour that unrelated parties *would have adopted* in comparable economic circumstances.

225. Applying the arm's length principle to CCAs focuses primarily on expected benefits and recognises that participants' contributions may take various forms (e.g. in cash, or in kind). Therefore, an argument in support of taking into account employee stock option plans in the context of CCAs would be that an independent enterprise dealing at arm's length and behaving in a commercially rational manner would not enter into a CCA which failed to account for a significant element of the enterprises contribution. In the above example (Section J.), Entity A would probably not enter into an arrangement in which it contributes all of the services in developing the intangible, where a significant part of the contributed compensation for such services is in the form of stock options, if Entity A received only 40% of the anticipated benefits from the arrangement (unless Entity B omitted an equally valuable element of its contribution).

226. Moreover, an independent party is unlikely to enter into a CCA that ignores valuable in-kind remuneration such as stock options. For example, assume that Entity A compensates its employees entirely in cash and Entity B compensates its employees only through stock options. In negotiating the CCA, the parties agree that their contributions will be valued on the basis of employees' remuneration and further agree on the value of the stock options provided by Entity B to its employees. In this case, independent parties would be expected to take into account the value of the stock options as failure to do so would ignore the contribution of Entity B, despite the fact that the parties agreed that those services were valuable. Of course, whether in-kind remuneration, including stock options, should be taken into account in any particular case depends on a determination of what independent parties acting at arm's length would do in the facts and circumstances of that case.

227. Finally, particular attention should be paid to cases where an employee's activity is only partially allocated to the CCA. The determination of what part of his or her stock options is to be allocated to the CCA may depend for instance on the criteria used to attribute the options, e.g. if the attribution of stock options is clearly linked to the success of a specific research program that falls within or outside the scope of the CCA (see paragraph 8.16 of the Guidelines on property or services that are used partly in the CCA activity and also partly in the participant's separate business activities).

L. WHERE STOCK OPTIONS ARE INCLUDED IN THE VALUATION OF PARTICIPANTS' CONTRIBUTIONS TO A CCA, WHAT SHOULD BE THE VALUATION PRINCIPLES?

L.1 *Costs or market value?*

228. Where it is established that stock options should be recognised in CCAs, the next question to be addressed is how to value those stock options. Unsurprisingly many of the same issues that were discussed in Situation I are relevant here too: the diversity of accounting treatments; the extent to which dilutive plans represent a cost etc.

229. Assuming it is established that employee stock options should be accounted for in a given CCA, key questions that arise are:

- Whether in the context of CCAs employee stock options should be accounted for at cost or fair value,
- What should be the measurement date
- And how to determine the period to which stock options are allocated.

230. For the purpose of determining whether a CCA satisfies the arm's length principle it is necessary to measure the value or amount of each participant's contributions to the arrangement (paragraph 8.13 of the Guidelines). Under the arm's length principle, the value of each participant's contribution should be consistent with the value that independent enterprises would have assigned to that contribution in comparable circumstances (paragraph 8.14 of the Guidelines). The existing guidance in paragraph 8.15 of the TP Guidelines does not only refer to costs in order to measure the value of contributions to arm's length CCAs, but also recognises that market prices can be used:

No specific result can be provided for all situations, but rather the questions must be resolved on a case-by-case basis, consistent with the general operation of the arm's length principle. Countries have experience both with the use of costs and with the use of market prices for the purposes of measuring the value of contributions to arm's length CCAs. It is unlikely to be a straightforward matter to determine the relative value of each participant's contribution except where all contributions are made wholly in cash, for example, where the activity is being carried on by an external service provider and the costs are jointly funded by all participants.

231. In valuing the participants' contributions to the CCA, one could take an approach that does not require costs of services rendered by participants' employees, i.e. remuneration, to be measured. Such a valuation method would refer neither to remuneration itself nor to any specific component of remuneration, but rather to the market value of the employee services that are contributed.

232. In other instances, remuneration costs are relevant to value the participants' contributions to a CCA. The conclusion of the discussions in Situation I is that a charge for stock options might be appropriate and is not dependent on whether the plan was dilutive or non dilutive. With respect to CCAs,

there are differing views. Some commentators argue that there is nothing in the 1995 TP Guidelines on CCAs to suggest radically different treatments of stock option plans depending on whether the plan is dilutive or non-dilutive. On the contrary the recognition in the Guidelines that depending on precise facts cost or market value may be more appropriate is consistent with the conclusion that if stock option plans must be accounted for in CCAs, the answer should be the same whether or not the plan is dilutive, and whether or not an actual cost is recorded in the financial accounts. Other commentators argue that the CCA Chapter in the Guidelines was not intended to address the issue of stock options, and that when an expense is not incurred, as in a dilutive plan, the opportunity cost should not automatically be assumed to be a contribution.

L.2 Measurement date

233. In theory, measurement date can be at grant date, at exercise date, or at any moment in between. Measurement date has an impact on valuation and should not be confused with the determination of the period over which stock options should be allocated (this latter question is being discussed in sub-Section L.3 below). The choice of the measurement date is linked with the risk allocation method and accordingly is one of the parameters that should be agreed upon by the participants to a CCA when entering into the arrangement (see paragraph 8.42 f) of the 1995 TP Guidelines).

234. In the example in Section J above, Entity A and Entity B could agree that valuation of their contributions to the CCA would include the grant date value of the stock options granted to Entity A's employees. This would mean that Entity B would not share in the subsequent risks of Entity's A stock options (in particular any increase or decrease in the value of the underlying shares). The main advantage of this approach is that it provides some certainty to Entity B (see argument described above with respect to *unpredictable* amounts when settlement is at exercise).

235. Another approach would be to share in the risk of the option in proportion to cost shares under the CCA. Applying this approach to the example in Section J above, Entity A and Entity B would agree at grant date to pay their appropriate proportionate shares of the spread between the stock price and the exercise price at exercise date (as well as associated administrative costs). Under this approach, it might be considered that this agreement, at grant date, to share in the spread at exercise date would be equivalent to an option contributed by Entity A to the CCA. Accordingly, the value contributed by Entity A at grant date could be determined by reference to the arm's length fair value of its stock options and it is the entry into the agreement itself at the grant date that would constitute the arm's length contribution to the CCA consistent with Article 9, notwithstanding the fact that actual payments from Entity A do not occur until exercise date. This approach also provides administrative convenience in two ways, i.e. first, there would be no need to value the option at grant date or at exercise date and second, the financial information required to settle the terms of the agreement under this alternative should be readily available (because it is the same information that the employees would need for verification that the option contract has been fulfilled).

236. Whether a particular allocation of risks (and accordingly measurement date) reflects an arm's length behaviour is a factual question and should be examined on a case by case basis.

237. An alternative view is that independent parties acting at arm's length would not have agreed to the risk allocation described above. According to this view, arm's length participants in a given CCA would not agree to share, at the outset (when the employee stock options plan is set up), a cost the quantum of which is uncertain while the associated risks that they would bear relate to input (labour) used by one member of the CCA. Under this view, the only valuation of the employee stock options for

purposes of recognition in the context of a CCA that is consistent with the arm's length principle is that which occurs at the time stock options are granted to the employees of the CCA participant(s).

238. A second possible concern with this approach is its apparent artificiality, i.e. it may be regarded as involving the introduction of two self cancelling transactions: one from the (parent) participating entity charging the (subsidiary) participating entity the fair value for the options awarded, and the second a put option from the (subsidiary) participating entity to the parent, the effect of which (from the subsidiary company's perspective) is to exchange a known price over a known time scale for an unknown price over an unknown time frame.

239. Finally, a possible concern is that methods based on the spread do not produce arm's length results because they are based on the benefits that employees obtain.

L.3 Period to which stock options are allocated

240. As discussed in Section C.1. (iii) above the period to which stock options are to be allocated depends on the purpose of the particular stock option plan, and in the first instance should be documented and determined in accordance with the purpose of the stock option plan. As far as the period to which CCA contributions in the form of stock options are allocated, it should in principle be the period of activity remunerated by the stock options. As indicated in earlier discussions, such an approach appears to rule out exercise date as the appropriate period in which to record the full cost of the options: options are never designed to reward employees for their services in the year of exercise, not least because at the date of grant the employer does not know which year the employee is going to exercise the options. Taking into account stock options at exercise date only would raise a number of difficult issues. First, this could mean a retroactive charge for services already consumed and even potentially relating to a period when the CCA was not yet in place. In addition, as described in Sub-section C.1 (d) (ii) above, the need to account for risks linked to potential increase or decrease in share value would generally require that participants be in a position, at the date of grant, to measure the contributions to the CCA or to agree on possible risk minimisation techniques. Subsequently, stock options could for instance be treated as costs in the period of services to which they relate.

241. This question can be illustrated by looking for example at a CCA concluded for a three year period starting on 1 January 2003 and ending on 31 December 2005. We shall assume that stock options are included in the valuation of participants' contributions to a CCA where such participants contribute to the CCA through the activity of employees so remunerated (Section K above). First, we shall consider the case where one participant to the CCA has granted stock options on 29 December 2002 with a vesting date on 29 December 2005. If stock options are regarded as remuneration of employment services for the period from grant to vesting date, almost all the value of these stock options should be allocated to the CCA. On the other hand, if stock options are remuneration of employment services for a period prior to the grant, their value should not be allocated to the CCA at all. Second, let us take the case of another stock option plan implemented with a grant date 29 December 2005. Under this approach, if the second stock option plan is remunerating future services to be performed after the termination of the CCA agreement, it should not be accounted for in the valuation of the participant's contribution to the CCA. But if it is remuneration for employment services rendered prior to the grant e.g. during calendar year 2005, its value should be accounted for. These examples illustrate the importance of a proper identification of the period of employment services remunerated through the granting of stock options, as was discussed in sub-section C.1 (b) (iii).

242. Given the perceived complexity of a tracing approach in practice, another approach that could be adopted for administrative reasons would be to determine a single point in time at which stock options would generally be regarded as a contribution to a CCA. This point could be for instance vesting date or grant date. Under such a rule, stock options would for instance represent a contribution to the CCA if granted to an employee whose labour at the chosen point in time (e.g. vesting date, date of grant) is related to the activity covered by the CCA.

M. INTERACTION BETWEEN TREATY RULES AND DOMESTIC RULES

243. According to paragraph 8.23 of the Guidelines,

Contributions by a participant to a CCA should be treated for tax purposes in the same manner as would apply under the general rules of the tax system(s) applicable to that participant if the contributions were made outside a CCA to carry on the activity that is the subject of the CCA (*e.g.* to perform research and development, to obtain a beneficial interest in property needed to carry out the CCA activity). The character of the contribution, *e.g.* as a research and development expense, will depend on the nature of the activity being undertaken by the CCA and will determine how it is recognised for tax purposes. [...]

244. Thus, where a participant to a CCA contributes by the activity of employees remunerated through stock options, said contribution should be treated for tax purposes in the same manner as would apply under the general rules of the tax system(s) applicable to that participant if it was offering stock options to employees performing similar activities outside the CCA.

N. PRELIMINARY CONCLUSION TO SITUATION III

245. There is currently limited experience and evidence of what unrelated parties actually do with respect to stock options when determining the value of participants' contributions to a CCA. It is only possible to hypothesise what unrelated parties might be expected to do at arm's length. There are arguments to consider that if stock options are remuneration, independent enterprises dealing at arm's length would not enter into a CCA in which a significant element of employee compensation was omitted from the determination of the participants' contributions. Some commentators have argued against the inclusion of stock options in CCAs based on their view that independent parties do not and would not include stock options in valuing participants' contributions to a CCA.

246. If one accepts that stock options are to be taken into account in valuing participants' contributions to a CCA, there is still a fundamental difference between a cost based approach and a market price approach to determine the value of a participant's contribution – both approaches are recognised by the Guidelines and this is an area where practices differ among OECD countries.

247. The period to which stock options should be allocated is of particular importance in the context of CCAs. In general, if stock options are regarded as remuneration for employment services rendered during the period starting at grant and finishing at vesting date, it follows that allocation to CCAs should follow consistently over the same period. Allocation as at a single point in time (e.g. grant or vesting date) may also be possible as an administrative convenience.