Stock-Based Compensation: Recharge Agreements, Transfer Pricing, and More

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Materials are not endorsed by or representative of any IRS official position.

Agenda

- Stock-based compensation fundamentals, Section 83 and award types
- Common Provision considerations
- Recharge agreements
- Transfer pricing policy, comparability and practical examples
- Country-specific treatment and implementation
- Section 162(m) updates and expanded covered employees
- Questions and discussion

What is Stock-Based Compensation?

A non-cash or cash-settled form of employee remuneration linked to equity value.

Employee Perspective

An opportunity to receive shares, share value, or cash linked to share value, usually subject to service, performance or market conditions. The award aligns retention and incentives with enterprise value.

Company Perspective

A compensation tool that can support retention, conserve cash, dilute shareholders and create accounting, payroll, securities and tax obligations.

Award value is not automatically the same as accounting expense, parent recharge, local tax deduction, employee taxable income or cash settlement.

Section 83 – the General Rule

- In general, the fair market value of property transferred in connection with the performance of services, less any amount paid for the property, is included in gross income at the time of the transfer
- Taxation is deferred as long as both:
  - The property is subject to a substantial risk of forfeiture, and
  - The property is not transferrable.
- Income recognized is compensation to the employee



Section 83(h) governs the deduction:

…there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which such property was transferred, an amount equal to the amount included under subsection (a), (b), or (d)(2) in the gross income of the person who performed such services….

Common Stock Based Compensation Award Types

Instrument	What the employee receives/U.S. Reporting	Company Deductibility/Provision treatment
Restricted stock (RSA)	Actual shares subject to restrictions. FMV of shares reported on Form W-2 for employees or 1099-NEC for contractors at vest, or at time of 83(b) election.	Deductible when income is reported – either at vest or at time of Section 83(b) election, if applicable, equal to amount included in income. Temporary difference: No 83(b): DTA over vesting; reverse at vest. 83(b): Upfront tax deduction may create a DTL that reverses with book expense.
RSUs	Promise to deliver shares or cash after vesting. FMV of shares/cash reported on Form W-2 or 1099-NEC at share transfer or cash payment.	Deductible at initiation of share transfer equal to amount included in income. Temporary difference: DTA set up as book expense is recognized, reverse at settlement
Incentive Stock options (ISOs)	Right to buy shares at exercise price equal to FMV at grant. Income inclusion and potential Form W-2 reporting occurs at sale depending on holding period.	Only deductible upon a disqualifying disposition in an amount included in income. Permanent difference: No DTA set up as the company doesn't expect to take a deduction
Nonqualified Stock options (NSOs)	Right to buy shares at exercise price. Spread value included as income on Form W-2 or 1099-NEC.	Deductible at exercise equal to amount included in income (spread value). Temporary difference: DTA set up as book expense is recognized, reverse at exercise.

Common Stock Based Compensation Award Types

Instrument	What the employee receives/U.S. Reporting	Company Deductibility/Provision treatment
Performance awards	Shares/cash based on targets. Income inclusion on Form W-2 or 1099-NEC at time of payment, share transfer or exercise.	Deductible at vest/exercise equal to amount included in income. Temporary difference: DTA set up as book expense is recognized, reverse at vest or settlement
ESPP / phantom / SARs	ESPP: Discounted shares. Reporting on Form W-2 depends on holding periods. Phantom: Cash payment reported on Form W-2 or 1099-NEC SAR: Payment reported on Form W-2 or 1099-NEC.	ESPP: Deduction depends on holding period. Permanent difference as company does not expect to take a deduction. Phantom: Deduction is at time of payment. SAR: Deduction equal to spread value at exercise. Phantom/SARs – DTA set up as book liability is established and reversed upon settlement

Common Issues in Provision (ASC 718-740) Calculation

Data gaps between the Equity reports can materially distort the stock-based compensation deferred tax asset if not monitored at grant level detail

1 Do the tax deductions claimed on the tax provision or returns materially match the amounts reported on W-2s/1099-NECs

Issue: What if system reports are used to determine tax deductions claimed on tax provision but were not essentially reported on the recipient's payroll

Risk: Tax deductions claimed on the provision/tax returns are OVERSTATED

2 ISO $100K rule not reviewed to determine the ISO vs NSO split

- Certain Equity systems treat a grant as one grant (ISO/NSO) rather than splitting into ISO vs. NSO separate grants.
- The split is important to determine the tax consequence
- ISOs are not expected to result in a tax deduction for a corporation, and the expense is treated as permanent book to tax adjustment impacting the effective tax rate
- NSOs are expected to result in a tax deduction and the expense associated
- Improper characterization could result in material tax provision and disclosure impacts for a corporation

Risk: DTA may be materially UNDERSTATED

Common Issues in Provision (ASC 718-740) Calculation

Data gaps between the Equity reports can materially distort the stock-based compensation deferred tax asset if not monitored at grant level detail

3 Modification expense outside the system

Often, companies record modification expense outside equity system.

Issue: If the modification expense is not factored correctly in the tax provision analysis, (1) the Deferred tax asset may not be set up correctly upon recording of the modification charge and (2) the Deferred tax asset may not be reversed out correctly upon activity.

Risk: DTA may be OVERSTATED or UNDERSTATED

4 Mobile and cross-border employees

Employee moves within or outside the U.S. can change the jurisdiction in which the deduction is available.

Issues:
(1) Is the SBC DTA set up appropriately in the jurisdiction where the deduction is expected to be realized?
(2) Does the tax deduction claimed in US tie to the amount reported as compensation on the recipient's W-2/1099-NEC as ordinary compensation.

Risk: U.S. DTA may be UNDERSTATED or OVERSTATED
Tax deductions claimed in US can be OVERSTATED or UNDERSTATED

NSO Exercises by Foreign Employee Working for a US Company NSO U.S. Deduction Analysis

Issue:	Can the U.S. corporation claim a §83(h)/§162 deduction when a foreign employee working for a US company is not taxed in the U.S. on the NSO exercise spread?
1. General rule:	• §83(h) generally links the employer deduction to the amount included in the service provider's income. • Foreign employees may have no U.S. income inclusion upon option exercise, raising the question on deductibility.
2. Foreign source income under Subchapter N	• Under Subchapter N, compensation for services performed outside the U.S. is generally foreign-source (§862(a)(3)). • For a nonresident alien, U.S. gross income generally includes only U.S.-source income and ECI (§872(a)).
3. Apply the bridge rule	• Reg. §1.83-6(a)(1) provides that amounts excluded under Subchapter N are deemed included in gross income for employer deduction purposes. • This rule prevents the employee-level exclusion from disallowing the employer deduction.
4. General position:	• The U.S. corporation may have a §83(h)/§162 deduction for the NSO spread if the services were performed for the US company.

Summary: Subchapter N explains why the employee is not taxed; Reg. §1.83-6(a)(1) is the bridge that preserves the employer deduction. However, different tax practitioners have different views about it so clarify the position with the auditors.

Foreign Branch/Foreign Contractors NSO Exercises: Subchapter N Deduction Bridge

(a)Allowance of deduction -

(1)General rule. In the case of a transfer of property in connection with the performance of services, or a compensatory cancellation of a nonlapse restriction described in section 83(d) and § 1.83-5, a deduction is allowable under section 162 or 212 to the person for whom the services were performed. The amount of the deduction is equal to the amount included as compensation in the gross income of the service provider under section 83 (a), (b), or (d)(2), but only to the extent the amount meets the requirements of section 162 or 212 and the regulations thereunder. The deduction is allowed only for the taxable year of that person in which or with which ends the taxable year of the service provider in which the amount is included as compensation. For purposes of this paragraph, any amount excluded from gross income under section 79 or section 101(b) or subchapter N is considered to have been included in gross income.



Stock-Based Compensation Recharge Agreements

Recharge Agreement Overview

1. Recharge agreement Basics

- Parent issues equity to employees of a foreign subsidiary. For most jurisdictions, the foreign subsidiary cannot take a deduction at the local level for the shares because they did not incur a cost.
- Depending on local law, the foreign subsidiary may need to bear/reimburse the equity cost through a recharge agreement to obtain a local corporate tax deduction.
- Recharge Agreements are binding agreements which obligate the foreign subsidiary to reimburse or pay the US parent for the value of the shares issued to the subsidiary's employees.

2. Mechanics / Repatriation of Cash

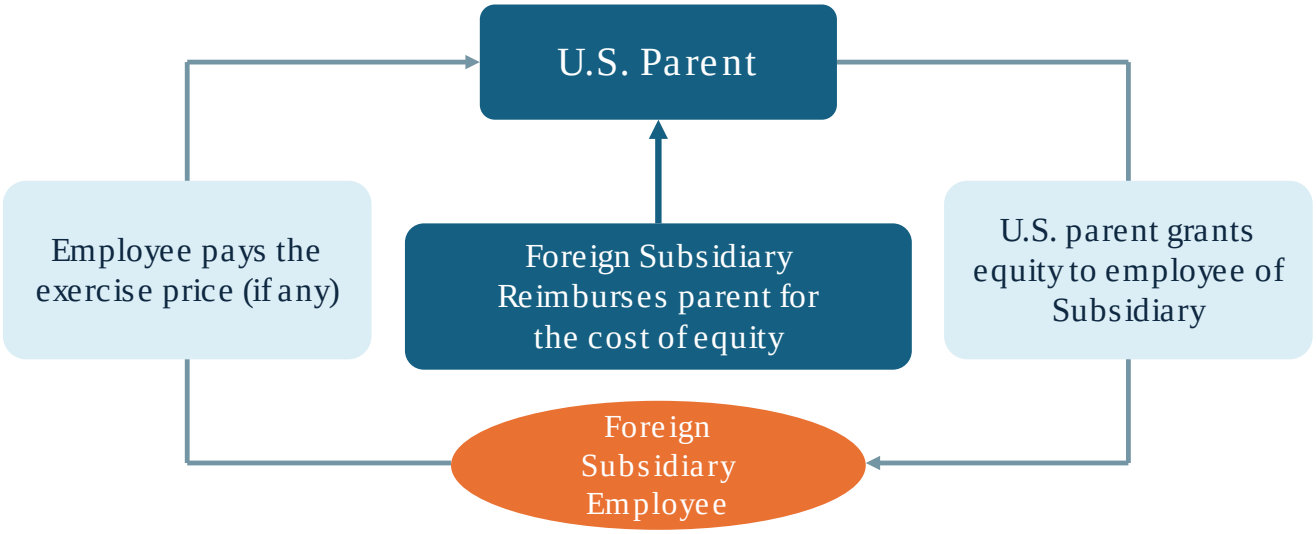
- Foreign subsidiary sends cash to the US Parent in accordance with the recharge agreement.
- Amount of payment depends on jurisdiction and is generally the value of the award.
- Enable a tax-free repatriation of cash which is not subject to taxable income to the US parent under Treasury Regulation Section 1.1032-3 if structured properly.

3. Challenges / Issues to Consider

- May increase social taxes
- May increase compliance with wage withholding &information reporting
- May present data privacy issues in certain jurisdictions
- May present administrative burdens with invoicing and fund transfers
- FXissues
- May create labor law issues
- Impact on transfer pricing

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Stock-Based Compensation Recharge Mechanics



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Stock-Based Compensation Recharge Agreements

Tax provision and GILTI/NCTI impact

1. Recharge agreement

- Parent issues equity to employees of a foreign subsidiary. Depending on local law, the foreign subsidiary may need to bear/reimburse the equity cost through a recharge agreement to obtain a local corporate tax deduction

2. Provision impact

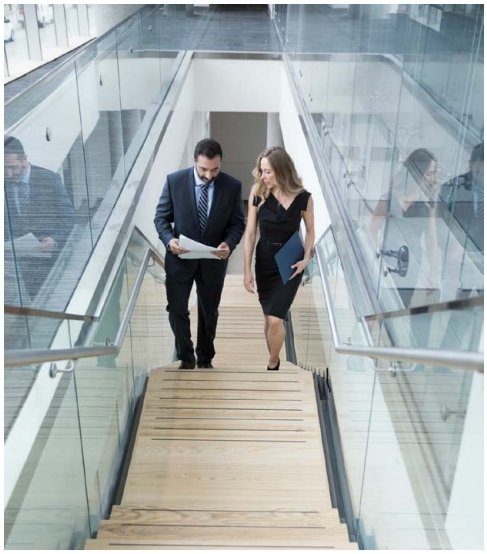
- If a recharge supports a future local deduction, the foreign subsidiary may record an SBC DTA based on cumulative book compensation expense and the applicable local tax rate.
- At settlement or exercise, compare the actual local deduction to the book-based DTA; excess tax benefit or tax deficiency generally runs through tax expense.
- Local law controls whether a recharge is required, the measurement of the deduction, and timing; assess UTP and valuation allowance implications by country.

3. GILTI / NCTI impact

- CFC tested income is computed under U.S. tax principles - not simply local statutory taxable income.
- If the CFC already receives the §83 compensation deduction for U.S. tested-income purposes, the recharge should not be deducted again in the GILTI / NCTI model.
- Recharge may reduce foreign taxable income and cash taxes, which can lower tested-income FTCs

Why SBC Matters for Transfer Pricing

1. It can materially change cost-plus charges, TNMM cost-based profit level indicators, and tested-party operating margins.
2. It is especially relevant for shared services, management fees, R&D, software development, IT, engineering, finance, HR, legal, tax, and treasury.
3. It can affect both the service provider's recovery and the service recipient's deduction or local controversy position.
4. It may be an economically relevant personnel cost even without an immediate cash outflow.
5. It can distort benchmarking when the tested party and comparables construct costs differently.



Core Policy Question

Should SBC enter the cost base, and if so, at what amount and with what markup?

Include

When it is compensation for in-scope service personnel, economically borne or recognized, method-consistent and comparable.

- It is part of the employee's compensation package, and the employee performs the controlled service.
- The employer or service provider records or economically bears the expense.
- An applicable legal rule expressly includes allocable SBC.
- Independent comparables incur and expense similar compensation.
- Exclusion would materially understate resources used to provide the service.
- The policy consistently treats salary, bonus and equity compensation as personnel costs.

Exclude or adjust

When unrelated to the service, shareholder in nature, duplicated, not borne, incomparable, immaterial or locally exceptional.

- The award relates to shareholder, stewardship, duplicative, incidental or self-benefit activity.
- The employee did not perform the relevant service, or the cost is not borne by the service provider.
- The amount is already captured through another entry or recharge.
- The comparable-company denominator excludes SBC, and inclusion creates a material distortion.
- The award relates to non-routine intangible development rather than an ordinary service.
- Local authority supports different treatment, the amount is immaterial, or volatility requires normalization.

Normalize / true-up

When volatility, timing or accounting differences materially distort the annual result but can be measured reliably.

The defensible answer is a conclusion from the framework, not a global presumption.

Major Authority Perspectives

Source	What it supports	Status / limitation
U.S. Treas. Reg. §1.482-9	Total services costs and methods for controlled services; express SBC language in paragraph (j)	Binding U.S. regulation; still transaction- and allocation-specific
OECD TP Guidelines 2022	Delineation, benefit, shareholder activity, cost allocation and method principles	Published guidance; no universal SBC bright line identified
OECD Chapter VII 2026 consultation	Modernization of intra-group service guidance and explicit SBC discussion	Draft consultation material, not adopted
UN Practical Manual 2021	Benefit, allocation, cost-plus and comparability principles	Principle-based; no universal SBC rule identified
IFRS 2 / ASC 718	Accounting recognition and measurement	Accounting standards, not transfer pricing rules

U.S. Regulations: Examples

Example 1 | Tested party omits SBC

Tested party: salary and other compensation = 1,000; stock-option fair value = 500 but omitted. Comparables expense SBC. Result: include 500 in the tested party's total services costs, increasing the denominator to 1,500.

Example 2 | Comparables do not expense SBC

Tested party has no SBC. Comparables grant options but do not expense them. Result: add disclosed fair value to comparable costs and reduce comparable operating profit when the utilization difference is material.

Example 3 | Difference is immaterial

The tested party includes option fair value of 50; comparables disclose smaller option amounts. The regulation concludes the difference would not materially affect the arm's-length result, so no adjustment is made.

Example 4 | Mixed comparable accounting

The tested party expenses SBC; some comparables expense it and others only disclose it. Result: normalize the non-expensing comparables when the accounting difference is material and reliably measurable.

Key point: First align total employee compensation, then calculate the net cost-plus PLI. The examples correct inconsistent cost construction; they do not say that every SBC amount must always receive a markup.

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Example A: Include vs. Exclude, Material RSUs in a Software Service Center

Hypothetical routine software service provider; 8% markup.

Item	Exclude SBC	Include SBC	Comment
Cash salaries and benefits	$10.0m	$10.0m	Direct personnel cost
RSU accounting expense	—	$4.0m	40% of cash compensation; clearly material
Other eligible costs	$2.0m	$2.0m	Occupancy, tools and allocated overhead
Total cost base	$12.0m	$16.0m	Before markup
Benchmark markup	8%	8%	Assume same range for illustration
Service charge	$12.96m	$17.28m	$4.32m difference

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Example A: Include vs. Exclude, Material RSUs in a Software Service Center

Hypothetical routine software service provider; 8% markup.

Why automatic exclusion fails

SBC is a major part of employee remuneration. Exclusion understates the resource cost if comparables expense similar awards.

Why automatic inclusion may fail

If comparable margins are computed without SBC, or the entity performs non-routine development, the 8% markup may be unreliable.

Difference and Effects

$4.32m higher charge

- $4.00 million recovery of SBC, and
- $0.32 million incremental profit from the 8 percent markup.

33.3% increase vs. exclusion outcome

Provider: higher revenue and profit dollars.
Recipient: higher service expense and potential deduction exposure.



Example B: Prevent Double Counting

Hypothetical parent grant and subsidiary service charge.

Step	Recorded amount	Correct treatment
Subsidiary records SBC expense with equity contribution	$3.0m	Eligible compensation expense, subject to activity mapping
Parent later issues recharge invoice	$3.0m	Settle contribution/payable or replace accounting basis; do not add again
Payroll report also lists “equity compensation”	$3.0m	Reference source only; exclude from separate payroll import
Eligible employee service percentage	80%	$2.4m enters chargeable pool before recipient allocation
Markup assumption	5%	$0.12m profit element
Total service charge attributable to SBC		$2.52m, not $6.30m

Audit trail

Award register → accounting journal → recharge invoice → employee/activity allocation → recipient allocation → service invoice

Red flag

The recharge invoice is posted to compensation expense even though the original parent contribution was never reversed.

Audit trail: award register → journal → recharge → activity allocation → recipient allocation → invoice

Transfer Pricing Treatment by Service Profile

Service profile	SBC relevance	Primary risk	Suggested stance
Routine accounting / HR	Usually low to moderate	Materiality and SCM/LVAIS eligibility	Consistent simplified convention
Routine IT support	Moderate	Confusing support with development	Separate support from software creation
Software / engineering	Often high	Unique intangibles and non-routine risk	Full delineation and comparability review
Contract R&D	High	Who controls risk and develops intangibles	Test service vs. CCA / IP arrangement
Management services	High for executives	Shareholder and parent self-benefit	Activity-based allocation
Sales / market support	Variable	Revenue linkage and local market intangibles	Employee-level mapping

The more employee talent and unique contributions drive value, the more important accurate delineation and comparability become.

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Comparability

Tested party	Comparables	Risk	Potential response
Includes SBC	Include and expense SBC	Generally aligned	Use reported data, subject to other differences
Includes SBC	Unknown or exclude SBC	Markup may be inconsistent	Review footnotes; adjust only if reliable
Excludes SBC	Include SBC	Understated tested denominator	Include SBC or normalize comparables
No SBC plan	Material SBC at comparables	Different compensation mix	Assess total compensation and materiality
Mixed comparable accounting	Mixed recognition / disclosure	Internally inconsistent range	Normalize disclosed amounts or use sensitivity

Make an adjustment only when the difference is material and reliably measurable.

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Timing and Measurement Alternatives

Basis	Advantage	Limitation / true-up issue
Grant-date fair value	Stable origin measure for equity awards	May diverge from settlement and tax result
Accounting expense over service period	Auditable and aligned with employee service	Forfeitures, modifications and liability remeasurement
Vesting-date value	Closer to value delivered and some tax regimes	Lumpy and potentially volatile
Exercise-date value	May align with option income and deduction	Employee-controlled timing; delayed from service
Settlement-date value	Objective amount delivered or paid	Can be delayed; misses service-period pattern
Tax deduction amount	Useful for local tax reconciliation	Tax rules are not the transfer pricing standard
Actual recharge	Clear invoice trail and legal claim	May lag service or use non-arm's-length formula

Country SBC Treatment: Positions and Implementation Actions

For routine cost-plus or TNMM service providers. Cost-base treatment is separate from corporate deduction, payroll and securities treatment.

EXPRESS / STRONG FACT-DEPENDENT ADVERSE / CAUTION

Jurisdiction	Cost-base position	Concrete authority / finding	What the team should implement
United States	Include	§1.482-9(j): SBC directly identified with or reasonably allocated to services is part of total services costs. §1.482-7(d)(3): grant-date SBC allocable to the IDA is an intangible development cost.	Map awards to benefiting personnel. Include allocable SBC in the service cost base and CSA pool. Document measurement, timing, allocation key and consistent treatment of comparables.
Israel	Include	Supreme Court, Kontera / Finisar: employee option expense of Israeli R&D service companies belongs in the cost-plus base even where the Section 102 capital-gains track denies a corporate deduction.	Include employee SBC in the cost base and apply the markup. Model the cash-tax effect separately because TP inclusion does not create deductibility.

Decision rule: include SBC when it remunerates the tested service employees and is borne or recognized as a service cost, unless local authority and the accurately delineated transaction support a different result.

Country SBC Treatment: Positions and Implementation Actions

For routine cost-plus or TNMM service providers. Cost-base treatment is separate from corporate deduction, payroll and securities treatment.

EXPRESS / STRONG FACT-DEPENDENT ADVERSE / CAUTION

Jurisdiction	Cost-base position	Concrete authority / finding	What the team should implement
Singapore	Include; YA2026 Concession	IRAS TP Guidelines, 9th ed. (4 Jun. 2026): SBC relating to intra-group services remains in the full-cost markup base. From YA2026, uncharged or notional SBC may be omitted from the final service income under the practical concession.	Calculate markup on the cost base including related SBC. For uncharged/notional SBC, document use of the YA2026 concession and reconcile markup base to invoiced revenue.
Ireland	Exclude on Case Facts	59TACD2024: Irish TAC allowed exclusion where the US parent bore the economic burden and risk, the Irish company made no recharge payment, and the agreement expressly excluded SBC.	Do not treat this as a blanket exclusion. Exclusion needs matching agreement, accounting, no recharge, economic-burden evidence and benchmarking support.

Decision rule: include SBC when it remunerates the tested service employees and is borne or recognized as a service cost, unless local authority and the accurately delineated transaction support a different result.

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Country SBC Treatment: Positions and Implementation Actions

For routine cost-plus or TNMM service providers. Cost-base treatment is separate from corporate deduction, payroll and securities treatment.

EXPRESS / STRONG FACT-DEPENDENT ADVERSE / CAUTION

Jurisdiction	Cost-base position	Concrete authority / finding	What the team should implement
India	Include if Borne / Recharged	Indian cases recognize ESOPs as employee compensation and allow actual parent cross-charges as business expense. TP treatment remains fact-specific, but a real recharge for Indian employees is generally an operating cost; a purely notional entry remains disputed.	If recharged, include as operating cost and apply the tested markup unless the policy supports pass-through treatment. Reconcile debit notes, employee population, deduction and comparables.
Australia	Arm's-Length Recharge; Deduction Not Assured	ATO International Dealings Schedule separately reports share-based remuneration recharges and expects an arm's-length methodology. ATO PBR 1052071465515 denied a deduction where the subsidiary lacked operational nexus and involvement in the awards.	Support who benefited, who selected participants and why the recharge remunerates Australian employees. Do not assume an accounting-expense recharge is deductible or automatically markable.

Decision rule: include SBC when it remunerates the tested service employees and is borne or recognized as a service cost, unless local authority and the accurately delineated transaction support a different result.

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Country SBC Treatment: Positions and Implementation Actions

For routine cost-plus or TNMM service providers. Cost-base treatment is separate from corporate deduction, payroll and securities treatment.

EXPRESS / STRONG FACT-DEPENDENT ADVERSE / CAUTION

Jurisdiction	Cost-base position	Concrete authority / finding	What the team should implement
Brazil / Italy	No SBC-Specific Rule Identified	Current TP regimes apply the arm's-length principle, but published SBC-specific cost-base authority was not identified in the reviewed materials.	Choose inclusion or exclusion from the accurately delineated transaction, accounting burden and benchmark denominator. Obtain local written confirmation before implementation.
China / Japan / Korea / South Africa / NZ	No Uniform SBC-Specific Rule Identified	General arm's-length and local tax rules apply. Public guidance reviewed did not establish one mandatory SBC cost-base result across these jurisdictions. Recharge, deduction, remittance and payroll outcomes remain locally driven.	Adopt a country memo covering employee nexus, recharge legality, deduction, withholding/payroll, FX or remittance controls, accounting entry and comparable-company consistency.

Decision rule: include SBC when it remunerates the tested service employees and is borne or recognized as a service cost, unless local authority and the accurately delineated transaction support a different result.

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Section 162(m)

Section 162(m) – Changing Landscape

For tax years beginning after December 31, 2026, the proposed Section 162(m) regulations expand the covered employee population, which may increase compensation deduction disallowances and compliance requirements.

- Expanded scope: Adds the next five highest-compensated employees, including non-executives, to the covered employee population.
- Greater deduction limitation: Broader coverage may increase permanent non-deductible compensation for corporations
- Higher compliance complexity: Requires broader compensation data, annual employee ranking, and enhanced provision modeling, including SBC-related Deferred tax impacts.



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Proposed Regs and Implementation of American Rescue Plan Act's Revisions to §162(m)

- On January 14, 2025, the IRS issued proposed regulations (REG-118988-22) that implement the amendments made to the TCJA covered employee definition in §162(m) by the American Rescue Plan Act (ARPA) of 2021
- The amendment expanded the number of "covered employees" whose compensation could be limited.
- §162(m) limitation calculation will include additional "five highest compensated employees" beyond the PEO, PFO and three highest paid executive officers already covered by Sec. 162(m).
- Expanded definition goes into effect beginning with tax years that begin after December 31, 2026.
- The proposed regulations provide that any employee of a corporation in the affiliated group may be in the ARPA 5 group regardless of whether the employee is an employee of or performs services for the publicly held corporation.
  - Allocation of Expenses: Proposed regulations clarify that remuneration paid by a CFC that is part of the group counts toward total compensation calculations to the extent the compensation expense is allocable to the publicly held corporation.
  - Deduction Disallowance: If a CFC pays compensation that is allocable or deductible against U.S. taxable income (or relevant subpart F/GILTI/deduction tracking mechanisms), it factors into whether the individual crosses the $1 million threshold and where the deduction is disallowed.

Proposed Regs and Implementation of American Rescue Plan Act's Revisions to §162(m)

Tiers	Covered Employees	Basis of measuring compensation	Once a covered EE, always a Covered EE?
Tier 1	PEO/PFO and anyone who has acted in that capacity during that year	N/A	YES
Tier 2	Top 3 "executive officers" of the company as defined in the Securities Act of 1934	Compensation reported under SEC rules	YES
Tier 3 (effective after December 31, 2026)	Top 5 compensated "employees/non-employees" of the company in the current year	Corporation's tax-deductible compensation	NO (Top 5 employees reassessed every year)
Tier 4	Tier 1 and Tier 2 covered EEs from prior year	N/A	YES

Note – Tier 3 can include Tier 4 covered employees but not covered employees from Tier 1 and 2.

QUESTIONS?

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