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AN ARM'S LENGTH ASSESSMENT OF THE ACCURATE DELINEATION OF EMPLOYEE STOCK OPTION PLANS[1]

Ricardo Sergio Schmitz Filho[2]
Mykolas Romeris University, Lithuania
Email: ricarfilho@mruni.eu

Elina Putnina[3]
University of Latvia, Latvia
Email: eputnina@deloittece.com

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Abstract. Employee stock option plans are increasingly common within multinational enterprises (MNE), used as tools to attract and retain talent. In many cases, the shares granted to the employees are not from the employer itself, but rather from another entity in the group, usually the parent. The paper aims to assess such employee stock option plans (ESOP) arm's length nature (or rationale), as this is perceived by the authors to be a fundamental step towards determining if (and how) any intra-group compensation is due. This aim is explored through the accurate delineation of the transaction and through the subsequent impact of this exercise on the frame of an eventual separate or aggregated compensation for an employee stock option plan. The paper is based on a comparative law assessment and especially focuses on the OECD, particularly Latvian and Lithuanian perspectives, and contributes to increased tax and legal certainty to MNEs operating in the selected jurisdictions, and to the overall operators of the tax systems therein. The analysis carried out indicates that such an ESOP is likely to be framed either as a form of service provision (priceable condition) or as a mere shareholder activity (non-priceable circumstance).

Keywords: Employee Stock Option Plans; Arm's Length Standard; Transfer Pricing; Accurate Delineation of the Transaction; Benefits Test.

Introduction

According to the OECD's already two decades-old report, "The Taxation of Employee Stock Options," (OECD Report, 2006) ("OECD Report") employee stock option plans (ESOP) can be defined as mechanisms which allow employees to acquire shares on favourable terms, subject to certain requirements and holding periods,

[1] The authors would like to thank Dr. Rafaelle Petruzzi for his valuable insights, and for fruitful discussions on the topics of this article.
[2] Lecturer at Mykolas Romeris University (Lithuania) and PhD Candidate at the University of Lisbon (Portugal) and Mykolas Romeris University (Lithuania), associate research of Centro de Investigação de Direito Europeu, Económico, Financeiro e Fiscal (Portugal).
[3] Lecturer at BA School of Business and Finance of the University of Latvia, member of the board of the Latvian Tax Consultants Association.

from the employer itself or from another company within the multinational enterprise (MNE), typically the parent company (OECD Report, 2006, p. 117).

ESOP cases in which shares are granted to employees of *another* MNE entity are increasingly seen in practice and are within the focus of this research. These are understood to be a way for large MNEs or fast-growing international start-ups to attract and retain talent within the group (OECD Report, 2006, e.g., p. 11). In both Latvia and Lithuania, a sharp increase in foreign direct investments (FDI), as corroborated by recent information from *Invest in Latvia* (Investment and Development Agency of Latvia, n.d.) and *Invest in Lithuania* (Invest Lithuania, 2024) has led to a higher presence of foreign MNE *subsidiaries* in the local economy, e.g., through the widespread establishment of foreign MNE shared service centres. This has contributed to increasing numbers of Latvian and Lithuanian entities having employees benefiting from ESOPs granted by foreign MNE parents. Additionally, the fast-growing local start-up MNE scene, in both Latvia and Lithuania, is reflected in an increase in cases of Latvian and Lithuanian *parents* granting ESOP to employees of foreign subsidiaries, as part of international expansion strategies.

A still unclarified issue, within the dynamics of ESOPs when granted to employees of *another* MNE entity, relates to the need for the MNE group to behave at arm's length. The arm's length is an internationally accepted standard, the authoritative statement of which can be found under Article 9 of the OECD Model Tax Convention on Income and on Capital (OECD Model Tax Convention, 2017, Art. 9). The latter prescribes that MNE entities must behave, in their intra-group relations, as independent parties. Historically, this has been called the (separate legal) *entity* approach (Chand, Turina, & Ballivet, 2020, p.567-568), aiming at ensuring that (taxable) profits are efficiently allocated between the individual entities and their countries of residence. Both Latvia (Saeima of the Republic of Latvia, 1995) ("Latvian Law On Taxes and Fees") (Cabinet of Ministers of the Republic of Latvia, 2018) ("Latvian Transfer Pricing Rules") and Lithuania (Minister of Finance of the Republic of Lithuania, 2018) ("Lithuanian Transfer Pricing Rules") adopt *variants* of the arm's length standard in their respective domestic legislation. As such, a question arises as to whether the intra-group relation from an ESOP granted by, e.g., a parent to employees of a subsidiary shall give rise to any form of *compensation*, from the latter to the former or in any other direction, i.e., whether such would be expected at arm's length.

Neither Latvian nor Lithuanian legal instruments provide *direct* answers to the above question, and both case law and academic literature in these jurisdictions fall short of providing adequate guidance on the matter. From a comparative law standpoint, the OECD has published the already mentioned OECD Report, and case law on this matter has proliferated in countries such as the USA, Ireland, India and Israel, despite a wide lack of domestic legislation specifically tackling the issue. Although answers to the (non)existence of a requirement of compensation are usually provided in these sources, as explored below, the analyses usually *neglect* a proper legal assessment of the nature (or *rationale*) of ESOPs from an arm's length perspective, which inevitably renders those same answers inconsistent (with legal theory, and among themselves), and somewhat *random*.

As a result, MNEs (taxpayers) and tax authorities alike face a scenario of tax and legal uncertainty on what shall be an adequate arm's length treatment – mirrored in the (non)existence of an intra-group *compensation* – of ESOPs, when granted to employees of another MNE entity. In both Latvia and Lithuania, these uncertainties can disrupt, or at least create unnecessary obstacles to, both the attraction of FDI and to the international expansion of local start-ups, due to increased tax risks. From a public standpoint, Latvian and Lithuanian budgets might suffer from potential under-allocation of MNE taxable profits locally, due to ESOP mispricing.

The aim of the present article is, therefore, to answer what shall be the grounds for the identification of the possible nature of ESOPs, paving the way towards a proper structuring of the underlying intra-group compensations, when deemed necessary, based on an arm's length logic, and focused on both the Latvian and the Lithuanian scenarios.

To achieve this aim, the article's objectives are twofold:

(i) To address the different possibilities of *accurately delineating* the relationship between the parent or other MNE entity from which the ESOP is granted and the subsidiary employing the benefited employees; based on the OECD Report, and especially on the OECD Guidelines and on comparative law definitions, whether ESOPs shall be categorized as a *financial*, an *intangible* or a *service* transaction.

(ii) Closely related to the above, to investigate the need, within an arm's length logic, for an intra-group *compensation* for ESOPs and, if applicable, under which frames, i.e., either as a *separate* transaction or *aggregated* with other transaction(s).[4]

The research employs a document analysis methodology. *Hard* and *soft* domestic and international law, and relevant jurisprudence are assessed. The research is also permeated by a comparative methodology, through critical assessment of solutions (or outcomes) provided by different operators (the OECD and selected jurisdictions) and their reflexes and iterations in Latvia and Lithuania.

The novelty of the paper lies in its pioneer analysis of ESOPs from an arm's length and transfer pricing perspective, with a focus on understanding its nature/*rationale*, rather than straight from a compensation standpoint, as commonly seen in both case law and academic literature. Neglecting what the authors believe to be the first (and fundamental) step towards the determination of an arm's length treatment for ESOPs renders case law, as mentioned but also existing academic literature, inadequate in providing answers to the identified issues and to this research's aim.

AI-assisted technology was not used in the preparation of this article.

1. The accurate delineation of ESOP

The initial step towards an adequate arm's length treatment of ESOPs, when provided to employees of another MNE entity, lies in the *accurate delineation* of this relationship, potentially a transaction, based on the OECD Guidelines, Chapter I. Accordingly, the accurate delineation of the relationship between the parties should consider elements of contractual terms (when applicable), functions performed, assets used, and risks assumed by the parties in the scope of the analyzed relationship, the characteristics of the properties transferred or services provided, the surrounding economic circumstances and business strategies underlying the relationship, the importance of which, in case law, was recently highlighted by, e.g. Abhishek Padwalkar (Padwalkar, 2024, sec. 3.1). This framework is particularly relevant, and has been prominent since the 1990's, but became even more consolidated from the early 2010's, as discussed in an interesting article from Pim Fris and Sébastien Gonnet on the occasion of the publication of the then-revised OECD Guidelines, in 2010 (Fris & Gonnet, 2010, sec. 2.1).

Although without explicit mention of the term "accurate delineation", or to a *direct* equivalent, both the Lithuania Transfer Pricing Rules (Minister of Finance of the Republic of Lithuania, 2018, e.g., Art. 3.1[1] and Art. 9) and the Latvian Transfer Pricing Rules (Cabinet of Ministers of the Republic of Latvia, 2018, Art. 2.2.5) establish the same need to assess a relationship between related parties through the prism of a functions, risks and assets assessment.

The elements found under the accurate delineation section of the OECD Guidelines are further analyzed through a different, rather specific, lens in different chapters thereof, relating to different broad categories of delineated

[4] The methods eventually to be applied to the *quantification* of such remuneration are outside of the scope of analysis of this article.

transactions, namely, financial transactions (Chapter X) or a mere capital contribution, intangibles (Chapter VI) and services (Chapter VII) – the latter possibly falling into shareholding activities and into merely incidental benefits.

In Lithuania, only the second and the third are separately analyzed, at least structurally, within the Lithuanian Transfer Pricing Rules (Minister of Finance of the Republic of Lithuania, 2018, Ch. 5, sections 1 and 2), given that its latest version *precedes* the introduction of the financial transactions chapter in the 2022 version of the OECD Guidelines, or even the publication of the OECD Transfer Pricing Guidance on Financial Transactions (OECD Transfer Pricing Guidance on Financial Transactions, 2020). In Latvia, these categories are *not* presented in structurally separate chapters or sections. Nevertheless, it is imperative to highlight that both Latvia and Lithuania largely follow (and rely on), in practice, the assessments of the OECD Guidelines in general, and in the accurate delineation exercise in particular.

As a first step towards an accurate delineation of ESOPs, the sub-sections below will cross-check under which broad category of transaction ESOPs should be analyzed, as this ultimately dictates the incidence of different assessments, based on the applicable Chapter of the OECD Guidelines. Sub-section 1.1 will assess whether an ESOP can be considered a financial transaction, sub-section 1.2 will assess whether an ESOP can be seen as an intangible traded between the parties, while sub-section 1.3 will assess the ESOP as a service provision or a shareholder activity, or as a mere incidental benefit.

Although this necessary – *delineation* – step is often neglected, both in the OECD Report and, as will be demonstrated, in case law, it remains a fundamental one. Without this step, establishing whether an ESOP is to be considered as a type of *condition,* something subject to bargaining between the parties and *usually* subject to an intra-group compensation, or as a mere *circumstance,* a given factor,[5] is often left blurred, further rendering the assessment of due compensation deficient, inconsistent with a proper application of the arm's length standard, and leading to *random*, arbitrary results in the profit allocation exercise among MNEs.

1.1. ESOP as a financial transaction

As mentioned above, neither Latvia nor Lithuania have specific sections or guidance on financial transactions within their domestic transfer pricing laws. The dictates of the OECD Guidelines must therefore apply locally; this is *expressly* prescribed in Lithuania (Minister of Finance of the Republic of Lithuania, 2018, Art. 96) and widely adopted in practice in Latvia.

Although Chapter X of the OECD Guidelines do not provide a clear "threshold test" on what – under an accurate delineation framework – would constitute a financial transaction, it does indicate that a financial transaction presupposes the *provision of funding* and/or the assumption and control of *financial risk* between associated enterprises (OECD Guidelines, para. 10.23-10.27), typically associated with a remuneration by reference to the time value of money or risk-bearing capacity. These are further expanded within the Chapter's comments on treasury functions (including intra-group loans, cash pools and hedging), financial guarantees and on captive insurance.

Despite the fact that these are not meant to form an exhaustive list of instruments which can be delineated and treated as financial transactions for transfer pricing purposes, they corroborate the indication of the need for a

[5] The terms *conditions* and *circumstances* shall be understood in accordance with their usage by Aitor Navarro *in*: Navarro, A. (2018). The Arm's Length Standard and Tax Justice: Reflections on the Present and the Future of Transfer Pricing. *World Tax Journal 10(3)*, 351-379. We will come back to these terms and their adequate contextualization below, *see* section 4.

provision of funding and/or the assumption and control of *financial risk* between associated enterprises, as mentioned above.
A typical ESOP thus cannot be delineated within the notion of financial transactions, as presented by the OECD Guidelines, as it does include the *provision of funding* and/or the assumption and control of *financial risk between* associated enterprises. Hence, a typical ESOP cannot be accurately delineated as a financial transaction, and thus falls outside the scope of Chapter X of the OECD Guidelines. A few specific points, nevertheless, deserve closer analysis.

We recognize that some confusion may arise as the shares, embedded in the ESOP, are expressly mentioned in the OECD Guidelines as *financial* assets (OECD Guidelines, para. 6.6, footnote 2), and they might be similarly treated in domestic legislation and accounting standards. It is important to clarify, nevertheless, that (i) the ESOP is a distinct element from the shares embedded within it and, (ii) a financial transaction is neither the same as nor necessarily involves a financial asset. Hence, Chapter X assessment is *not* triggered by the mere existence of or relation with financial assets or instruments. It is triggered, as mentioned above, by funding arrangements and financial risk allocation between associated enterprises.

An additional point of confusion may arise when a specific ESOP foresees the transfer of shares from the parent to the subsidiary *prior* to the actual transfer to the benefited employees. In these cases, we foresee three potential scenarios:

i. Shares are transferred from the parent to the subsidiary without compensation and with the intent of strengthening the subsidiary's equity, without any significant risks transferred – *capital contribution*. In these cases, the relation is not even within the scope of the arm's length standard, Article 9 of the OECD Model Tax Convention on Income and on Capital (OECD Model Tax Convention, 2017, Art. 9) and the OECD Guidelines, and is therefore not subject to the scope of analysis of this article.

ii. Shares are sold to the subsidiary, and economic ownership, including market risk, is transferred – *sales transaction*. In these cases, Chapter X still does not apply, and the transaction is to be accurately delineated based on the general command of Chapter I. Here, it is very likely that the ESOP is no longer a related-party transaction *following the sales*, but instead a transaction exclusively between the subsidiary and its employees.

iii. Shares are transferred for an administrative/operational purpose, the subsidiary is not the economic owner of the shares, nor does it bear all significant risks – *activity*, potentially a *service transaction*. In these cases, Chapter X still does not apply, and the transaction is to be accurately delineated based on the general command of Chapter I and on Chapter VII (services). We will discuss these cases under sub-section 1.3below.

Finally, the fact that an ESOP might be related to financial transactions, e.g., cases under which certain guarantees or funds exists to protect the ESOP, does not mean that the ESOP in itself is a financial transaction under the terms of Chapter X, applicable, as we have established, in both Latvia and Lithuania. Due care must be taken in the separate or transactional basis delineation exercise of the different intra-group transactions eventually taking place.

1.2. ESOP as an intangible asset

In contrast to the financial transactions above, a definition of intangible, for transfer pricing purposes, *can* be found in Lithuania, under which intangible assets are those "assets which are not in material form and do not

fall within the scope of financial assets, including copyright, access to industrial property, franchises, information on industrial, commercial or scientific know-how (know-how), databases, computer programs, etc., which can be managed, owned and may be disposed of or controlled for direct and/or indirect economic benefits, where the transfer or provision of such assets would be remunerated by non-associated persons acting in comparable circumstances, regardless of whether such assets are entered in the taxpayer's accounts" (*our translation*) (Minister of Finance of the Republic of Lithuania, 2018, Art. 3.7).

In Latvia, the definition of intangibles (rather, intangible *investments*) applied in the transfer pricing *praxis*, is found under the Law on Annual Statements and Consolidated Statements, as "(…) properties other than financial assets which meet both of the following classification criteria: a) they can be separated or divided from an undertaking and sold, transferred, licensed, leased or exchanged (individually or together with another liability or asset) or they have arisen from a contract or other rights regardless of whether such rights are transferable or separable from the undertaking or from other rights and obligations; b) an undertaking plans to use them for more than one year and expects that economic benefits will be received from holding of such properties" (Saeima of the Republic of Latvia, 2015, Art. 1,15).

According to the OECD Guidelines, an intangible is something which is neither a *physical* nor a *financial* asset, "(…) capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstance." (OECD Guidelines, para. 6.6). This definition is mirrored in the UN Manual on Transfer Pricing (UN Manual, para. 6.1.2.3) and a similar notion of intangible is found under other domestic regimes, as in England, stretched by the HMRC's Internal Manual (HMRC, INTM440110).

Concerned with not excessively narrowing the concept of intangible, and similarly as in Chapter X, the OECD Guidelines provides a non-exhaustive list of examples of intangibles for transfer pricing purposes, noting, once again, potential misalignments with accounting treatments. Examples of intangibles, under Chapter VI of the OECD Guidelines, include patents, know-how and trade secrets, trademarks, trade names and brands, rights under contracts, and licenses.

It is worth mentioning that both the Latvian and the Lithuanian legislations, as well as the above HMRC example, among others, use more explicit terms such as *asset* or *property* when talking about intangibles. The questions arising from an accurate delineation standpoint, as reflected in HRMC's Internal Manual, revolve around understanding whether the ESOP can be seen as an asset or property, i.e., whether the ESOP can be owned/controlled and, if so, whether, by itself, it would be worth anything at arm's length.

Prima facie, it is our understanding that an ESOP does *not* constitute a proprietary asset, as, in contrast to the Lithuanian and OECD examples listed above, it tends to disappear once the employees exercise the rights to acquire the shares (i.e., it disappears after use). This longer-standing nature of an intangible is interestingly highlighted within the Latvian definition (Saeima of the Republic of Latvia, 2015, Art. 1,15). Normally, an intangible asset does *not* disappear upon use, in contrast to, for example, the performance of an *activity*.

Secondly, it is hard to perceive the idea of the ownership of an ESOP, especially if seen through the possibility of exercising an *enforceable entitlement* to it, as stipulated in the OECD Guidelines, Chapter VI (OECD Guidelines, Chapter VI), and as extended in the Latvian definition above (Saeima of the Republic of Latvia, 2015, Art. 1,15), given that the ESOP would likely *not* be subject to legal protection normally applicable to intangibles.

Finally, intangibles are usually perceived as being capable of generating income directly from use, or indirectly, through licensing, as also described in Latvia (Saeima of the Republic of Latvia, 2015, Art. 1,15) – an ESOP would do so only *indirectly* (through retention of talent) but would hardly be licensable.

Although the considerations above might be less straightforward than the ones made under sub-section 1.2 above, *praxis* shows that no case law known to the authors has, at least recently, even if tacitly, treated ESOPs as an intangible. In conclusion, we agree with the understanding that an ESOP cannot be deemed an intangible, for the purpose of the applicable laws in Latvia, Lithuania and for the purpose of Chapter VI of the OECD Guidelines.

1.3. ESOPs as services or shareholder activities or incidental benefits

The sections above have concluded that ESOPs can neither be viewed as financial transactions nor as intangibles, but have also led to the perception that they can be *activities*.

According to the OECD Guidelines, the simple performance of an *activity* from one MNE entity to another is not, nevertheless, enough for the said activity to be characterized, or delineated, as a service, and for Chapter VII to apply in the delineation efforts of the transaction. A *benefits test* is a crucial step towards this delineation – the activity must provide the recipient with "economic or commercial value to enhance or maintain its business position" (OECD Guidelines, para. 7.6). This statement is further reflected in – or tested – based on the analysis of the willingness of the party to, instead, pay an independent enterprise for a similar activity or to perform it in-house for itself (OECD Guidelines, para. 7.6).

Failing to pass a benefits test, from the subsidiary's perspective, might render the ESOP a mere *shareholder activity*, from the perspective of the parent, or as providing for a mere *incidental* benefit, from the perspective of the subsidiary. The first case is presented by the OECD Guidelines as activities related to more than one MNE entity or to the group as a whole, such that the MNE entities would not need or would not be willing to pay for them, if provided by an independent party. The shareholder activities are therefore those performed in the interest of the shareholder, in its capacity as such (OECD Guidelines, para. 7.9-7.10). Shareholder activities are *not* deemed as services provided. Incidental benefits are seen as cases under which a certain MNE entity incidentally receives a benefit upon the activity of another MNE entity, which was not performed directly for the first. As with shareholder activities, incidental benefits are also unlikely to fall under those which the MNE entity incidentally benefited would be willing to pay for (OECD Guidelines, para. 7.12). Additionally, incidental benefits are also seen as those arising merely due to the affiliation of the MNE entity with the group (OECD Guidelines, para. 7.13), in "absence of *deliberate* concerted actions or transactions leading to that benefit [to the recipient]" (*our highlight and addition*) (OECD Guidelines, para. 1.178).

In both cases, it is not that benefits do not exist – they likely *do* – it is that they are mostly perceived by the performing entity or by another entity, *not* the subsidiary under analysis.

In Latvia, neither does a separate assessment exist for service transactions, as mentioned, nor is a *benefits test* clearly described in the legislation, being only briefly mentioned within a slightly different context, for the delineation of low value-added services (Cabinet of Ministers of the Republic of Latvia, 2018, Art.4.5), also leaving the notions of shareholder activities and incidental benefits rather unexplored. Despite the absence of explicit benefits test requirements for service provisions, these can be observed in practice.

In Lithuania, on the other hand, the notion of a benefits test is presented within a specific section devoted to service provisions in the Lithuanian Transfer Pricing Rules (Minister of Finance of the Republic of Lithuania,

2018, Art. 69-70), under which the OECD's notion of willingness to pay, as we have presented above, is clearly reflected.

The first step towards understanding whether an ESOP can be considered as a service provision from the parent to the subsidiary or as a mere shareholding activity or incidental benefit lies, therefore, in establishing which entity ultimately *benefits* from the ESOP. Perhaps an inaccurate perception that a benefits test would *always* point towards the subsidiary employing the employee part of the ESOP as directly benefitting is a reason why this (necessary) step was neglected by the OECD Report (OECD Report, 2006, p.122), and a tacit consideration of ESOP as inherently a service provision was made.

The sub-sections below will explore the identification of the benefits of the ESOP (and the parties benefitted) to understand whether an ESOP can be accurately delineated as a service provision or as a shareholder activity – the first likely to entail an intra-group *compensation*, the second not.

1.3.1. Identification of the benefits of and the parties benefitted by an ESOP

It is our understanding that, according to the OECD Report, the fact that a parent entity would *not* grant share options or provide any other type of remuneration to employees of an unrelated party without expecting anything in return would *necessarily* mean that a *service provision* exists (and a compensation would be due) based on the wording of Article 9 of the OECD Model Tax Convention on Income and on Capital (OECD Report, 2006, p.122) (OECD Model Tax Convention, 2017, Art.9), the only exception pointed out being the cases under which the ESOP is instead seen as a capital contribution, but those are outside the scope of our analysis, as they were also from the OECD Report (OECD Report, 2006 p.122, footnote 4).

We cannot side with such a positioning. Firstly, the OECD Guidelines, in many instances, recognize that relations between related parties might differ from those between unrelated entities, without necessarily violating the arm's length standard – an *unbridged levelling* (Navarro, 2018, p.361). An example of this is the wording of paragraph 1.142 of the latter document (OECD Guidelines, para.1.142). Secondly, both the ideas of shareholder activity and incidental benefits cohere with the fact that, in a related party scenario, as opposed to one involving an unrelated party, a parent can *potentially* create or obtain a *direct* benefit through the granting of ESOPs to employees of another entity (hence impairing an eventual delineation of the ESOP as a service provision).

This stems from the *time* evolution of the arm's length standard, from which a growing understanding of the intrinsic differences between associated and independent parties' behaviours has developed and must be considered in an arm's length assessment – contrary to a more traditional view of the standard's *rationale*, as also discussed within the works of Avi-Yonah and Benshalom (2011, sec. 2), and Fleming, Peroni, and Shay (2020).

In the US, an interesting illustration of this evolution can be found, although framed within a slightly different context involving the intersections between ESOPs, cost sharing agreements and the arm's length standard. In US vs Xilinx Inc. (U.S Court of Appeals, 2009), the Ninth Circuit of the US Court of Appeals sided with a 'traditional' view on comparability requirements of the arm's length standard, representing what we have above called the *unbridged levelling*, borrowing the expression from Aitor Navarro. Later, nevertheless, the same Ninth Circuit of the US Court of Appeals sided with our understanding of the *actual* meaning of comparability within an arm's length logic, in line with its *time* evolution, when deciding on the US vs Altera Corp.[6] (U.S Court of Appeals, 2019), defending that the arm's length assessment must aim at achieving an arm's length

[6] Later confirmed in *United States v. Altera Corp., 19-1009 (U.S. Supreme Court, June 22, 2020).*

result, more than a mere application of certain arm's length methods (U.S Court of Appeals, 2019, para.49), especially so when a certain behaviour does not traditionally find comparable cases in scenarios involving independent parties.

It is important is to note, therefore, that a parent *can* potentially obtain, for itself, an *actual* economic benefit out of an ESOP granted to employees of a subsidiary, *despite* such not being factually observed in unrelated-party cases – a shareholder activity or an incidental benefit. Although both US vs Xilinx Inc. and US vs Altera Corp. were somewhat discussed in academia,[7] they relate to transfer pricing discussions (and the need for an underlying transaction) of ESOP costs incurred with one's *own* employees – which is a different scope than considered in this study, and consequently we will not dive deeply into these cases.

All in all, the benefits of the ESOP being *primarily* seen at the level of the parent or at the level of the subsidiary will ultimately lead to our classifications below as to whether the ESOP isa *circumstance* or a *condition,* and hence, respectively is a mere shareholding activity or incidental benefit, or is a service provision, which determines whether compensation is indeed due between the related parties.

To clarify the differences between a *circumstance* and a *condition*, one must resort to the understanding of the very nature (or *rationale*) of the arm's length standard. According to Aitor Navarro, this rationale can be viewed either from the perspective of a *full* arm's length fiction or from the perspective of a *limited* arm's length fiction (Navarro, 2018, p.361-366). Elsewhere, we have rather presented those as different points within an entity v. enterprise approach *continuum*, in the consideration of group interests or relations in the arm's length *praxis*, the first being the reflex of a strict entity-based arm's length standard, while the second represents a step towards the incorporation of elements of an enterprise view in the core of the arm's length.[8]

Siding with the understanding that a *limited* arm's length fiction prevails in contemporary practice, a *circumstance*, i.e., something which is a given factor, not subject to the will of the parties (Navarro, 2018, p.361), i.e., leading to potential *incidental* benefits, shall, therefore, *not* be priced.

The understanding that these incidental benefits shall not be priced is corroborated by the OECD Guidelines, which, in its paragraph 7.13 state that "(…) an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed (…)." (OECD Guidelines, para.7.13), the consequence of which a payment is not due. This is also explicitly corroborated by the Lithuanian Transfer Pricing Rules, which state that "(a) service to a taxpayer is also not considered to be provided if the provision of that service was intended to benefit another entity and the benefit received by the taxpayer is only incidental, or where the taxpayer benefits solely from being a member of a particular group of units" (*our translation*) (Minister of Finance of the Republic of Lithuania, 2018, Art. 72).

On the other hand, a *condition*, defined by Aitor Navarro as a feature of the transaction that *is* subject to bargaining between parties (Navarro, 2018, p.361), shall usually be subject to compensation/be priced.[9]

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[7] At least, they were mentioned as key development transfer pricing points in 2021 *in*: Scuderi, E., & Holzinger, R. (2021). 2021 WU global transfer pricing conference: "Transfer pricing developments around the world." *International Transfer Pricing Journal, 28*(4), 256.

[8] These considerations are further elaborated within the corresponding author's doctoral dissertation, not yet published.

[9] Although we have, elsewhere advocated in favour of exceptions to this statement based on the existence of a *rational business conduct*, we will neither present this distinguishment nor discuss its potential exceptions, for the scope of the present analysis.

The points below will, therefore, present the key elements in understanding whether an ESOP should be viewed as a *circumstance* or, alternatively, as a *condition* between the parties.

1.3.2. The ESOP as a circumstance

In a recent Irish Tax Appeals Commission's decision ("Irish Case"), an appellant provided sales, marketing, and R&D services *exclusively* to its non-resident parent under intercompany service agreements (Tax Appeals Commission, 2024, e.g., para.253). The parent retained all strategic and decision-making powers and bore all entrepreneur risks related to the transactions carried out with the appellant, assuring the remuneration of the latter based on a cost-plus model (Tax Appeals Commission, 2024, para.254, 262). As part of the parent's policy, the latter offered to employees of its diverse subsidiaries an ESOP aimed at incentivizing and retaining key personnel across the group, and all decisions on the terms of the plan were made centrally by the parent (Tax Appeals Commission, 2024, para.234 ff). The ESOP was agreed directly between the parent and the employees across the different subsidiaries of the group, including the appellant to the case, without participation of the latter. No contracts/agreements were in place between the parent and the appellant in respect of the ESOP (Tax Appeals Commission, 2024, e.g., para.235).

We have, similarly, encountered a situation under which a certain subsidiary provided IT development services *exclusively* to its parent company and was also guaranteed a remuneration based on a cost-plus model. Likewise, all strategic decisions and most of the entrepreneur risks lay with the parent company. An ESOP was in place under which the parent company, similarly to the Irish Case, would offer to selected key employees of the group, at the sole and absolute discretion of the parent, an opportunity to participate in the ESOP for advantageous options to acquire shares of the parent. The ESOP was designed mostly to align those key employees' long-term interests with those of the main shareholders, and, as such, maintain talent in the group.

In both cases, the ESOP was granted based on certain eligibility criteria, defined exclusively at the level of the parent and over which the subsidiaries had no bargaining power. The subsidiaries, likewise, had no decision-making power on the eligibility of the employees or any other element of the ESOP, illustrating that *value* was actually created for the parent,[10] as a benefits test would likely highlight, clearly pointing out the ESOP as *circumstances* from the point of view of the subsidiaries.

The facts of both cases indicate that the employees would still have been granted the ESOP, *independently* of which subsidiary of the group they were employed by – the subsidiaries, not providing services to any other party than their own parents, are, therefore, obtaining nothing more than an *incidental benefit*, if at all, in the terms of para. 7.13 of the OECD Guidelines, and so likely not enhancing their economic or commercial position.

From a transfer pricing perspective, in such cases, actual *economic* costs incurred by the parent shall stay at the level of the parent as long as the benefits test indicates that such (ESOP) costs were incurred to its own benefit, as per the cases illustrated above. The indirect spillover on the subsidiary is to be seen as an *incidental circumstance* and *benefit*, and thereby not priceable under our understanding of a light enterprise approach (or *limited* arm's length fiction, in Aitor Navarro's terms) (Navarro, 2018, p.361-366), as embodied in current OECD Guidelines. This was the understanding of the court in the Irish Case, and seems not to have yet been contested by any tax authority in the cases we have illustrated based on our own experience.

In contrast, the Supreme Court of Israel nevertheless erred, in our view, when jointly deciding the *Kontera* and the *Finisar* cases (Supreme Court of Israel, 2018), factually very similar to our above-collected cases and analysed by Hubscher and Houlie (Hubscher and Houlie, 2018), and by Finley and Hoke (Finley and Hoke,

[10] As noted by the Commissioner in the *Irish Case*, supra n. 23, para. 231 and 236.

2018), by stating that an ESOP shall be understood as an economic cost to the subsidiaries, as they contribute to generating income at the level of the latter (Supreme Court of Israel, 2018). We believe that the generation of the income does not automatically amount to the maintenance or enhancement of the economic and commercial position of the party, as it does not automatically mean that the party would be willing to pay an independent party for a similar activity. The assessment of the Israeli court seems, therefore, not backed up by a benefits test, in the specifics of the factual circumstances of the cases, potentially leading to a non-arm's length outcome.

It is important to highlight that our above understanding – contrary to the Israeli cases – also helps to prevent a *circular remuneration* or *contaminated cost-base*. As such, an eventual pricing of the ESOP would end up returning to the parent as an *inflated cost* (i.e., added by a mark-up), as part of a cost-plus remuneration for the subsidiary's services (on a likely *full*-cost-plus scenario), which would create a misalignment with the arm's length standard, i.e., the parent paying for the subsidiary for a function (and underlying risks) ultimately performed/undertaken by *itself*.

Taxpayers and tax authorities alike must roll their eyes, especially, at cases under which, despite our understanding above of the ESOP as a non-priceable circumstance, for *accounting* purposes, the subsidiary is required to book these costs. Note that an important distinction must be made – as in the decision of the Irish Case – between mere *accounting* costs and actual *economic* costs (Tax Appeals Commission, 2024, e.g., para. 227). The mere fact that accounting standards dictate the need for ESOP-related costs to figure in the subsidiaries' financial statements does not automatically mean that those costs are the subject of a transaction (i.e., priceable condition) between the parties, as it should not influence corporate income taxes.[11] Naturally, this does *not* alter our classification of the ESOP as a (non-priceable) circumstance, as the costs are merely *formally* incurred by the subsidiary.

Based on the cases presented, therefore, one can state that it is very likely that for an ESOP within the premises of this analysis to be considered a (non-priceable) circumstance (and *not* a service provision from the parent to the subsidiary), the subsidiary must provide services *only* to the parent and have, by the latter, a stable guaranteed remuneration.

Such cases do not seem to be reflected in the OECD Report, but the proliferation of real-life applications of such, and even more so the Irish Tax Appeals Commission's decision, set important grounds for the practical adoption of this solution, including in Latvia and Lithuania, when applicable, as a faithful reflex of the arm's length standard, in spite of the Israeli decisions reported above.

1.3.3. The ESOP as a condition

On the other hand, in many cases, the result of a benefits test on an ESOP might indeed highlight direct benefits obtained by the subsidiary employing the employees involved in the plan. This can be seen in cases where the entity whose employees benefit from the ESOP increases the value to its *own* business operations (e.g., sales

[11] A concern well expressed by Barbara Voskamp and Anne Klaassen, when exploring the same Irish Case, considering the scenario in Singapore: Voskamp, B., & Klaassen, A. (2025). Tax and transfer pricing challenges of stock-based compensation in Singapore: Analysis and practical insights. *Asia-Pacific Tax Bulletin, 31*(3). This point was also raised by the Income Tax Appellate Tribunal of Bangalore, although, that court sided with our understanding within this paragraph, e.g.: *M/S I2 Technologies Software Pvt Ltd v. Commissioner of Income Tax, IT(TP)A No. 274(Bang)/2014 (Income Tax Appellate Tribunal, Bangalore Bench A, April 21, 2017)*, para. 21 and *M/S Sprinklr India Private Limited v. Deputy Commissioner of Income Tax, IT(TP)A No. 713/Bang/2022 (Income Tax Appellate Tribunal, Bangalore Bench C, January 11, 2023).*, para. 9.1.

and/or services provision to third parties using the benefitted employees) and, thus, having a *direct* benefit. In these cases, the subsidiaries are also very likely to be willing to incur equivalent costs to make employee remunerations more attractive, intrinsically related to improving or maintaining the subsidiary's commercial position (OECD Guidelines, para. 7.6) (Minister of Finance of the Republic of Lithuania, 2018, Art. 69-70).

Another element which *can* indicate the direct benefits obtained is whether the subsidiary is also somehow involved in the determination, to some extent, of the elements of the plan, e.g., higher participation in control over risks, thus making it more or less clear the existence of a *condition* between the subsidiary and the parent or other MNE entity whose shares are granted, instead of a mere *circumstance*, as in the previously collated cases.

The OECD Report presents several variations of an example of an ESOP (OECD Report, p. 120-133), based on an enterprise which grants stock options to the employees of an associated enterprise that is resident in another tax jurisdiction (OECD Report, p. 120-133). Despite the many considerations made by the OECD Report, what we have above noted as the lack of a proper benefits test in the latter is revealed by the presumption that – to a greater or lesser extent – the subsidiary in which the employees part of the ESOP are employed *always* benefits from the ESOP, including in cases in which the subsidiary only provides services to associated parties. As such, we understand that the OECD sees an ESOP, within the frames of our analysis, to always be a *condition*, or a service provision.

Although we disagree with the OECD Report's assessment, an ESOP is indeed, in multiple cases, to be seen as a (priceable) condition established between the parties in the scope of a service provision. Take, for example, the case of a subsidiary engaged in research and development and engineering projects, both to its parent entity in a different jurisdiction, and to several third parties. Certain key employees of the subsidiary (i.e., senior researchers and engineers) are offered by the parent to participate in an ESOP. These employees work on several projects, including those provided to third parties. The subsidiary, undertaking high value-adding functions, taking significant market and other risks, and owing significant tangible and intangible assets, is, therefore, remunerated by its parent on a per project basis, with prices established based on project margins, similarly to the method adopted by the subsidiary in establishing its prices with the third-party clients.

In conclusion, it is our understanding that an ESOP, *prima facie*, is very unlikely to be considered as a financial instrument and/or as an intangible. The focus of the accurate delineation of the transaction, therefore, is a *benefits test*, within scope of Chapter VII of the OECD Guidelines, to determine whether the ESOP is to be viewed as a service provision or as a shareholder activity or incidental benefit, as discussed above. This distinction would inevitably need to be performed on a case-by-case basis.

For the cases under which the ESOP is *not* viewed as a service provision, based on the dictates of the OECD Guidelines and the applicable legislation (and *praxis*) in Latvia and Lithuania, it is likely that no intra-group compensation is due. Alternatively, compensation for a *service provision* is expected.

2. The compensation for an ESOP as a separate or an aggregated transaction

The points below briefly present when an ESOP is deemed as a provided service and a priceable condition exists, whether this service is to be delineated as a *separate transaction* or as part of a broader service offering (i.e., *aggregation*) as a combined transaction. The second possibility is foreseen by the OECD Guidelines (2022, para. 3.9-3.12), and in Lithuania (Minister of Finance of the Republic of Lithuania, 2018, Art. 14). In Latvia, although commonly seen in practice, this possibility is not expressly mentioned in the legislation.

2.1. The ESOP as a transaction in itself

An ESOP shall be treated as an independent, identifiable service provision transaction when the focus is on the provision of the stock options by one MNE entity to employees of another MNE entity. The analysis of an appropriate *separation* or *aggregation* of transactions is a crucial step for the analysis of specific cases.

As we have identified above, the ESOP will only be a transaction in itself and subject to a remuneration if a benefits test has been fulfilled, identifying – *de facto* – that a transaction exists (i.e., the subsidiary employing the employees partaking of the plan obtains a *benefit* from the parent or other MNE entity whose shares are granted), the absence of which would inevitably lead to a non-compensation scenario. The ESOP cannot be priced as a transaction in itself if it is seen as a *circumstance* between the parties. As a transaction in itself, the ESOP can be priced through different prisms, or by the consideration of distinct elements, including through the *shares* embedded within it (e.g., from a costs' perspective) and/or for the administration of the plan.

Although the OECD Report proposes different means of quantifying the remuneration for an ESOP based on these and other prisms, we recognize that the *quantification* exercise, now justified by a more solidly accurate delineation process, contains its own questions and specificities and is outside of the scope of this article.

2.2. The ESOP as part of another transaction

The OECD Report also recognizes that an ESOP may not always be isolated, but may be ancillary to other intra-group relations (OECD Report, 2006, p. 120). Within this approach, the ESOP would be viewed as a component of broader service transactions, such as manufacturing or distribution arrangements. The ESOP would not itself be the focus of a controlled transaction but would affect the pricing of other intra-group dealings by influencing employee remuneration and performance (i.e., be part of people's costs). This would follow the different possibilities for the aggregation of transactions, for transfer pricing purposes.

Naturally, whenever an ESOP is understood as a *circumstance*, it *cannot* also be accounted for in the context or as part of another transaction between the subsidiary employing the employees part of the plan and the parent or other MNE entity whose shares are granted. If that would be the case, the parent or other MNE entity whose shares are granted in the ESOP would end up paying to the subsidiary, e.g., through a cost-plus mark-up for the pricing of another transaction, for a benefit it creates to itself, which is contrary to any arm's length logic,[12] as we have already determined.

Note, nevertheless, that the costs of an ESOP incurred by that parent, as per the scenario above, could naturally still be considered in that entity's remuneration for other transaction(s) with *other* counterparties, when applicable, e.g., when it is deemed appropriate to consider the costs of the ESOP in that other dealing. But in such cases the relationship would no longer be between a subsidiary by which the employee part of the plan is employed and its parent or other MNE entity from which the shares are granted.

Depending on the specifics of the case, one type of ESOP remuneration (either as a transaction in itself or as part of another transaction) would not necessarily exclude the other, it being possible for them to co-exist and the ESOP accounted for in different contexts. An example of that could be of a parent granting an ESOP to the employees of a subsidiary. The subsidiary would use the work of the employees to provide services to other related parties (i.e., sister companies), indicating that benefits are perceived by that subsidiary which were due to the parent's granting of the ESOP. The ESOP is then to be remunerated as a transaction in itself, and an underlying payment is to be made by the subsidiary to the parent. The subsidiary then, utilizing the employees

[12] As corroborated in the *Irish Case*, supra n. 23, para. 290 ff.

part of the ESOP, would include the underlying ESOP costs (i.e., to the parent), in the cost-base of its service provision to its sister companies, thus, the ESOP would be seen as part of another transaction(s).

Conclusions

The analyses carried out have highlighted that a proper transfer pricing treatment of (the nature/*rationale* of) an ESOP, when granted by a parent or another MNE entity different than the one employing the benefitted employees, shall begin with a solid exercise of *accurate delineation* of the relationship between the MNE parties involved. This step, although *theoretically* consolidated in the OECD Guidelines, is often neglected by both the OECD itself, within the OECD Report, the existing case law on the subject and, to a certain extent, by both Latvian and Lithuanian legislation. Lack of accurate delineation of the ESOP inevitably renders the analysis of any eventual consequent intra-group compensation deficient, and compliance with the arm's length standard uncertain.

The article confronted ESOPs with the dictates of Chapter I on the accurate delineation of transactions, but also with the important specificities of Chapters X (financial transactions), Chapter VI (intangibles), and Chapter VII (services), as well as with equivalent provisions, when available, in both Latvian and Lithuanian legislation, concluding that an ESOP, as an activity, is very unlikely to be considered either as a financial transaction or as an intangible in the authors' jurisdictions, as in those largely following OECD standards. Further legal and tax certainty towards that position could, nevertheless, be achieved with the adoption, by both Latvian and Lithuanian legislations, of more detailed sections, reflective of the content of the three above-mentioned specific OECD Guidelines chapters, as a way to strengthen the accurate delineation exercise within local practices.

The classification of an ESOP's nature (or *rationale*) as either a service provision or as a mere shareholder activity or an incidental benefit lies upon the performance of a *benefits test*, which we have confronted with the different forms that an ESOP can appear in MNE *praxis*. Lack of further development of the benefits test might impair this assessment. It is recommended for Latvian and Lithuanian transfer pricing operators, therefore, strengthen their observance of the accurate delineation exercise and, within a *potential* service provision analysis, to resort to an adequate *benefits test*.

We have, therefore, concluded that an ESOP can be either a service and seen as a (priceable) *condition*, or a shareholder activity or incidental benefit and seen as a (non-priceable) *circumstance*. This conclusion has a significant importance for understanding the boundaries of the existence intra-group compensation – either of the ESOP as a transaction in itself (separate pricing) or of the ESOP as part of another transaction (aggregate pricing) and, at a later stage, to an arm's length quantification of this compensation.

As presented above, it is recommended that the determination of the *frames* of this remuneration, either as a *separate* transaction or *aggregated* with other transaction(s), follows the understanding on whether the ESOP is an integral part of another transaction or, on the contrary, shall be seen as a transaction in itself. The authors recognize that this exercise must be done, following the guidance provided in this article, on a case-by-case basis, and that this exercise is intrinsically surrounded by a certain subjectivity.

Finally, neglecting the above guidance might render a transfer pricing/arm's length assessment deficient, especially of an ESOP, whose characteristics, as discussed in the article, does not clearly point towards a single direction. Due care in this exercise shall help taxpayers to effectively comply with the arm's length standard, for them and tax authorities alike to benefit from enhanced tax and legal certainty, as well as providing an even better scenario for attracting MNE investments and for the international expansion and development of local start-ups from both Latvia and Lithuania.

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