

Cross-Border Taxation of Employee Stock Options: How to Improve the OECD Commentary – Part 2

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3. Allocating Stock Option Benefits to Different Periods of Services

3.1. General remarks

3.1.1. In general

In practice, most of the difficulties involved in the taxation of employee stock options in cross-border situations arise in the determination of the services to which the options relate. The most important issue to address is whether the options may be regarded as rewarding previous performance or as an incentive for future performance.

The case law in various jurisdictions shows that methods of allocating income to the employment exercised in the work state differ considerably. The current Commentary to Art. 15 of the OECD Model does not specify the exact method that must be used for this allocation.

3.1.2. A time-proportionate method is the starting point

In general, a time-proportionate method should be used to determine which part of the salary must be allocated

to the employment exercised in the work state. The time-proportionate method is appropriate if the employee in question performs his activities in both states (i.e. the work state and the residence state) and if his remuneration has a connection with the services rendered in the work state. The basis for this allocation is the exercise of the employment in the work state, which, in most cases, means that the employee has to be physically present to render services in that state. An exception applies if a certain part of the remuneration has to be attributed exclusively to the labour performed in the work state.

Under this time-proportionate method, the remuneration is allocated to the services rendered in the work state by using a fraction where the *numerator* generally consists of the actual number of days in which an employee was present to perform the services and the *denominator* is the total number of working days. The definition of the numerator and denominator may, however, vary in different jurisdictions.

There are income components that should be exclusively attributable to the employment exercised in the work state, such as benefits in kind that depend on the profits earned by the company on whose behalf the services are rendered in that state or benefits that can only be linked to the employment exercised in the work state or have a closer connection with services rendered in a particular state.⁷⁵ An example of such income components would be stock options granted by a foreign employer to compensate services that the employee renders exclusively for the benefit of that employer.⁷⁶ The authors believe that specific elements or income components could justify a departure from the time-proportionate method because they are exclusively attributable to employment exercised in the work state. Therefore, they must be taken into account in the ultimate allocation of the compensation to the services rendered in that state. This would also be in line with the words "as is derived therefrom" in Art. 15(1) of the OECD Model.

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75. Decision of the German Federal Tax Court of 29 January 1986, BStBl. II 1986, p. 479.

76. It should be noted that the Report is silent on this possibility.

3.2. Approaches taken by national tax courts and tax administrations

3.2.1. The Netherlands

Decree of the Under-Minister of Finance, 19 August 1994 V-N 1994/2812

In a Decree of 19 August 1994⁷⁷ the Under-Minister of Finance outlined his view on the cross-border taxation of stock options. His view was based on a decision of the Court of Appeals of Amsterdam of 23 October 1985, *BNB 1987/79* relating to the taxation of a cash bonus. On the basis of this decision, the Under-Minister of Finance took the view that a time-based attribution of stock option benefits was not to be applied under Netherlands tax treaties. The Under-Minister of Finance, nevertheless, changed his view in 2002.

Decree of the Under-Minister of Finance, 11 February 2002, V-N 2002/14.14

In this Decree the Under-Minister of Finance replaced his 1994 view with a time-based attribution approach. The Decree applies to all stock options becoming unconditional after 1 January 2002. The Decree of 19 August 1994 is no longer of relevance to these stock options. However, as the authors discuss below in more detail, the Hague Court of Appeals applied a time-based attribution of stock option benefits to a situation prior to 1 January 2002 and rejected the principles laid down in the Decree of 19 August 1994.⁷⁸

According to the Decree, the benefit must be attributed to the different countries in which the employment is performed and to which the options have a connection. The Decree takes the position that "benefits from stock options should be allocated on a pre-granting basis in the case of unconditionally granted stock options."⁷⁹ Unconditionally granted stock options are considered to remunerate the employee's performances during the period preceding the options being granted because at that moment the employee is fully entitled to dispose of those options.⁸⁰ Conditional stock options are regarded as remuneration of future performance. They must be allocated to the state where the employee worked during the vesting period. The vesting period will not be decisive for the allocation of the benefits resulting from conditional stock options if the facts and circumstances demonstrate that another period has to be taken into consideration.

Netherlands Supreme Court, 3 October 2003, BNB 2004/9

The Hague Court of Appeals allocated the stock option benefits on the basis of the time spent in the Netherlands (i.e. the work state) between the granting of the options and the moment they became unconditional (i.e. the vesting).⁸¹ Remarkably, the Court of Appeals did not use a day-based fraction, but instead based the allocation on the entire time period between the granting and the vesting of the options (i.e. 12 months).⁸²

The sole issue under discussion during the Supreme Court appeal was the value of the option benefits. The Under-Minister of Finance did not appeal against the approach adopted by the Hague Court of Appeals in respect of the allocation of these benefits since it followed the Decree of V-N 2002/14.14.⁸³ Consequently, it is not entirely clear whether the Under-Minister has also accepted the application of this Decree to cases before the Decree entered into force on 1 January 2002, although this conclusion could be derived from the fact that the Under-Minister did not appeal against the Court of Appeals' stance in this respect.⁸⁴

3.2.2. Finland

In its decision *KHO 1998/2148* and *KHO 1998/2199*, the Finnish Supreme Administrative Court held that the benefit resulting from stock options was only taxable in Finland in proportion to the time spent in Finland dur-

77. Decree of 19 August 1994, V-N 1994, p. 2812.

78. Based upon the principle of legitimate expectations (*vertrouwensbeginsel*), a taxpayer may, in the authors' view, still rely in certain cases on the principles set out in the Decree of 1994 if he prefers such a method to a time-based attribution. See also J.C.A. van Ruiten, *Fiscale en juridische aspecten van werknemersparticipatie* (Amersfoort: SDU, 2003) p. 125.

79. I.e. options that can be exercised immediately or options that vest over time, but which are not subject to the condition of continuous employment.

80. C. Bobbett and J.F. Avery Jones, "Tax Treaty Issues relating to Cross-Border Employee Stock Options", *Bulletin for International Fiscal Documentation* 1 (2003), p. 5, note that, during the discussions at the IFA seminar, it was thought that such pre-granting requirements were unusual in practice. However, in determining this period, the 2004 Report also requires all the facts and circumstances to be taken into account (see Para. 30 of the Report and Paras. 12.11 and 12.13 of the 2005 Commentary on the OECD Model).

81. The question as to the relevant period for sourcing options has historically been unclear. In *Rev. Rul. 69-118*, the stock option benefits were allocated on a temporal basis to the services rendered outside the United States by a resident taxpayer of the United States. It is striking that this Revenue Ruling based the allocation on the period between the granting and exercising of the options. *Private Letter Ruling 8711107*, however, followed the period between granting and vesting; the IRS concluded that where a non-resident alien of the United States exercised a stock option, income from the exercise was earned as the services were performed over the period in which the option holder's right to the option was vested. The resulting compensatory income was taxable in the United States, based on the percentage of days worked in the United States during each year of the vesting period. Furthermore, the *Private Letter Ruling* also implies that it may be appropriate to allocate on the basis of an employee's relative compensation from the granting date to the exercise date. See E. Wielobob, *U.S. Taxation of Compensatory Stock Options in the International Context. An Overview of Some Current Issues*, *Tax Management International Journal* 2004, No. 1, p. 22 and T.St.G. Bissell and A. Giardina, *International Aspects of U.S. Retirement Plans. Deferred Compensation Plans: An Overview*, *Tax Management International Journal*, 1996, No. 5, p. 275. Under *Treas. Reg. § 1.861-4(b)(2)(ii)(F)*, which became effective as of 1 January 2006, the relevant period for making the determination is generally the vesting period of the options (See also E. Tanenbaum, *Sourcing Compensation and Allocating Charitable Contribution Deductions*, *Tax Management International Journal*, 2005 No. 11, p. 648).

82. The Decree of 11 February 2002 also based the allocation on an entire time period (12 months) in its examples, without referring to the day-based fraction.

83. As a result, the Under-Minister not only accepted the time-proportionate allocation of the stock option benefits, but also the inaccurate time period fractions that the Court of Appeals had taken into consideration, i.e. 3/12 and 4/12 instead of 4/12 and 5/12. See also the remarks made by the Editorial Board of V-N 2003/50.15.

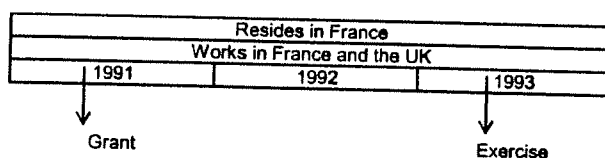
84. This approach was chosen by the Editorial Board of V-N 2003/50.15. However, a degree of caution is appropriate in drawing this conclusion because the possibility that the Under-Minister had other reasons for not appealing from the Court of Appeals' decision in respect of the allocation of stock option benefits cannot be excluded.

ing the period between granting and exercise compared to the total time between the granting and exercise.⁸⁵

3.2.3. France

The Lower Administrative Court of Versailles, 18 December 2001, Copson, R/JF, 6/02, No. 690

In its decision of 18 December 2001, *Copson*, R/JF, 6/02, No. 690 the French Lower Administrative Court of Versailles ruled on the attribution of the right to tax stock options derived by a French resident in a year in which he partly exercised his employment in the United Kingdom.⁸⁶ In 1993 the taxpayer exercised his employment for 161 working days in France and 20 working days in the United Kingdom. His remuneration was borne by the French parent company for the employment exercised in France and by a UK subsidiary for the employment exercised in the United Kingdom. In that same year, the taxpayer also exercised an option, which was granted in 1991, to acquire stock in the French company and immediately sold the shares acquired under the option.



The Court held that, under Art. 15 of the treaty, the right to tax the stock option benefits was attributed to the United Kingdom to the same extent as the regular employment income in the relevant year:

20 (days on which the employee performed activities in the United Kingdom)

181 (total number of days on which actual activities were performed in that calendar year)

Consequently, France had to grant an exemption for 20/181 of the stock option benefits because the taxation rights on these benefits was attributed to the United Kingdom.

The taxpayer in this case argued that the period between the granting (1991) and exercise (1993) must be taken into account when attributing the stock option benefits to the employment exercised in the United Kingdom. This would have resulted in the following fraction:

340 (UK working days)

480 (total working days)

The Lower Administrative Court of Versailles rejected this reasoning by pointing to the absence of an explicit provision on this issue in the France-UK tax treaty. For this reason, the Court referred to French domestic law, under which only the calendar year should be taken into consideration, providing the stock option benefits were taxed as employment income in the year of exercise.

Analysis

It is obvious that the approach taken by the Lower Administrative Court of Versailles could have caused more difficulties if the employee had worked in a state (before moving to France) that taxed the stock options at the time of their being granted, while they were exercised when the employee resided and worked in France. Similar problems could arise if both contracting states were to tax the stock options upon exercise, whereby (i) France would base the attribution on the situation in the year of exercise, while (ii) the other state would allocate the taxation rights by taking the period between granting and vesting⁸⁷ or exercise⁸⁸ into consideration.

This could be resolved by including the relevant period for attributing stock option benefits in a tax treaty provision. The United States and the United Kingdom chose this solution in the Exchange of Notes accompanying the 2001 UK-US tax treaty.⁸⁹ The Exchange of Notes states that the stock option benefits must be allocated on a time-proportionate basis, depending on where the employee worked during the period between the grant-

85. See the annex to the EU Commission's "Study on Employee Stock Options", Finland, Para. 4.3.2. Finland follows a view similar to the previous view of the UK tax authorities. With effect from 6 April 2005 the United Kingdom follows the approach adopted in the Report and in the 2005 OECD Commentary. For options exercised on or after that date, the United Kingdom will base any apportionment on the period of employment up to the vesting date; see *Tax Bulletin*, April 2005, No. 76.

86. For a description of this decision in English, the authors refer to *Tax News Service*, 26 August 2002, pp. 491-492.

87. The 2004 Report (Paras. 32-34) and the Commentary (Para. 12.14 of the 2005 Commentary on Art. 15) follow this approach by allocating the right to tax the income from options to the source state in which the employee worked during the vesting period. For a more detailed discussion, see C. Bobbett and J.F. Avery Jones, "Tax Treaty Issues relating to Cross-Border Employee Stock Options", Seminar F at the 2002 IFA congress in Oslo. The OECD Model Convention - 2002 and beyond, IFA@2002, p. 3 (also published in *Bulletin for International Fiscal Documentation* 1 (2003), op. cit., p. 5) noted that there was considerable agreement on this approach during the discussions at the seminar. With effect from 6 April 2005 the UK HMRC follows the OECD Report and the 2005 Commentary.

88. After the publication of the first Discussion Draft (March 2002), this approach was initially followed by the German Ministry of Finance; see resolution of the Ministry of Finance of Nordrhein-Westfalen of 27 March 2003, BB 2003, No. 21, p. 1095, to which the Federal Ministry of Finance agreed (an exception is allowed when the employee at issue retires in the period between grant and exercise; in that case the option benefits must be allocated based on the period between grant and the retirement): according to the resolution of the German tax authorities of 14 September 2006, point 6.6.2, the stock option benefits were allocated based on the services rendered between grant and vesting, provided that they concern non-tradable options (*nicht handelbare Optionsrechte*) or tradable options (*handelbare Optionsrechte*) that are conditionally granted (i.e. with a blocking period). Furthermore, this was the original view in the UK HMRC Double Taxation Relief Manual DT1925, DT1925A and DT1925B (see also *Tax Bulletin*, No. 60, August 2002, pp. 51-954; *Tax Bulletin*, No. 56, December 2001, pp. 895-899; *Tax Bulletin*, No. 55, October 2001, pp. 883-887). With effect from 6 April 2005 HMRC follows the 2004 Report and the 2005 Commentary, i.e. apportionment based on the period of employment between grant and vesting; D. Cohen, "Share options and internationally mobile employees", BTR 2002, No. 5, pp. 369-371 and P.J. Moroz, "Mobile Options", *Taxation*, 28/2/2002, p. 2; of the Finnish Supreme Administrative Court (*KHO* 1998/2148 and *KHO* 1998/2199) and of the Austrian tax authorities (EAS 2357 of 14 October 2003, *SWI*, 2003, p. 534; EAS 2504 of 18 August 2004, *SWI* 2005, p. 89, EAS 2552 of 28 December 2004, *SWI* 2005, p. 358 and EAS 2532 of 15 November 2004, *SWI* 2005, pp. 51 and 52).

89. Also, the 2003 tax treaties between the United Kingdom and Australia and between the United States and Japan include a similar provision, as does the 2006 Australia-UK tax treaty.

ing and the exercise of the option.⁹⁰ It is useful to note that, in general, both the United States and the United Kingdom tax the stock option benefits upon exercise.⁹¹ From a US tax perspective, it was not entirely clear which period should be used as the basis for allocating the stock option benefits; on the one hand, this allocation was made by taking account of the services rendered between grant and exercise,⁹² while, on the other hand, the period between grant and vesting was used.⁹³ This lack of clarity when the 2001 UK–US tax treaty was negotiated has been resolved as far as that tax treaty is concerned. *Treas. Reg.* 1.861(b)(2)(ii)(f) and (g)⁹⁴, example 6⁹⁵ clarifies that the stock option benefits, generally, must be allocated on the basis of the period between the grant of the option and the vesting of the option.

The United Kingdom and Australia also included a specific provision in their tax treaty in which the relevant period is mentioned that must be used to allocate the stock option benefits. Point 8 of the Exchange of Notes to the 2003 Australia-UK tax treaty states that, unless the facts otherwise indicate, the period of employment to which the option relates must be taken to be the period between the grant of the option and the date on which all the conditions for its exercise have been satisfied (i.e. the vesting of the option). In this event the taxation rights over the option are effectively pro-rated according to the days of employment in the period spent in the United Kingdom and Australia. This broadly reflects the position in the 2004 Report, which is discussed below. The Exchange of Notes also defines the day-based fraction that must be utilized to make the appropriate allocation of the stock option benefits as follows:

number of days of employment exercised in the work state between grant and vesting of the option

total number of days of employment exercised between grant and vesting of the option⁹⁶

A solution is harder to achieve if one state (i.e. the residence state) taxes the stock option benefits when granted and attributes them to a pre-grant period (State R), while the other state taxes them upon exercise and bases the attribution upon the working days during the period between the grant and exercise of the options (State W).⁹⁷ Suppose the employee worked and resided in State R in the period before the options were granted. State R's tax authorities believe that the benefits are taxable in full in that state upon vesting. In the period after the grant of the options and until they were exercised, the employee exercised his employment exclusively in State W while remaining a resident of State R. State W takes the view that it may tax the entire benefit upon exercise of the options. This could lead to situations of double taxation or double non-taxation, for which neither the Commentary nor the 2004 Report provide a solution.⁹⁸ Double taxation and double non-taxation could be avoided in these situations by the inclusion of an explicit provision in a given tax treaty, protocol or exchange of notes accompanying the tax treaty to the effect that the attribution of the stock option benefits would be based either on the services rendered in the

years before the options were granted or on the period between the grant and vesting or exercise.

3.3. Approach in the 2004 Report

3.3.1. Options granted for past or for future services

The determination of whether and to what extent an employee stock option is derived from employment exercised in a particular state must, in each case, be made on the basis of all the relevant facts and circumstances, including the contractual conditions associated with that option. The 2004 Report states that the following two principles are decisive.

As a *first* general principle, employee stock options should not be considered to relate to any services ren-

90. Although the 2004 Report and the 2005 Commentary take the working days during the period between the grant and vesting of the options as the basis for allocating the stock option benefits to employments exercised in various countries, they leave scope for contracting states that are negotiating a bilateral tax treaty to adopt a different approach. Para. 12.15 of the 2005 Commentary expressly mentions the situation of two contracting states that both predominantly tax options upon exercise. These states may agree, as a general principle, to attribute the income from options that relate primarily to future services to the services performed by an employee in two states between the date of grant and the date of exercise. In addition, the Commentary states that Member countries of the OECD should be careful about adopting such approaches because they may result in double taxation or double non-taxation if part of the employment is exercised in a third state that does not apply a similar approach.

91. Bobbett and Avery Jones, *Bulletin for International Fiscal Documentation* 1 (2003), op. cit., p. 3 note that the allocation of the right to tax the income from the options to the source state on the basis of where the employee worked during the vesting period has the advantage that the company knows the date of vesting in advance, but not the date of exercise. Using the vesting date consequently makes calculation easier.

92. *Rev. Rul.* 69-118.

93. *Private Letter Ruling* 8711107; *Private Letter Ruling* 9037008 (mentioned by J. Lebersorg and J. Pattyn, *Internationale Aspecten van aandelenopties; fiscale analyse door een Belgische Bril, A.F.T.* 2004, No. 5, p. 27).

94. This regulation became effective for taxable years beginning on or after 14 July 2005.

95. This example uses entire years and months to determine the appropriate attribution of the stock option benefits.

96. Apparently this day-based fraction is only applicable when the following conditions are satisfied: (i) the period of employment to which the share option relates is the period between the grant and the vesting of the option; (ii) the employee remains in that employment at the date of alienation or exercise of the option; and (iii) that employment has been exercised by the employee in the other contracting state during all or part of the period between the grant and the vesting of the option.

97. See also the mutual agreement which the Dutch and Belgian competent authorities concluded in this respect (resolution of the Netherlands Ministry of Finance of 21 February 2007, No. IFZ07-45). Although the reason for this mutual agreement was to resolve transitional issues that arose with respect to stock options granted to employees falling under the former frontier workers regulation (Art. 15(3) of the 1970 Belgium–Netherlands tax treaty), it illustrates these kinds of allocation difficulties. Belgium taxes stock options at the moment when they are granted whereas the Netherlands taxes these options when they are exercised (and before 1 January 2005 when they vested or were granted unconditionally). When options were granted before 1 January 2003 to an employee residing in Belgium, they were taxed at that time (under the former frontier workers regulation Belgium had the exclusive authority to tax these benefits). When these options had become unconditional or would vest after 1 January 2003, the Netherlands (work state) would also tax these benefits (the Netherlands had the authority to tax these benefits pursuant to Art. 15(1) and (2) of the 2001 Belgium–Netherlands tax treaty: the frontier workers regulation had been abolished under this treaty). If the employee can demonstrate that the stock option benefits were already taxed in Belgium when granted, the Netherlands is willing to forfeit its right to tax.

98. Para. 32.8 of the 2000-2005 Commentary on Art. 23A and 23B of the OECD Model does not resolve this issue. Another approach is followed by the Austrian tax authorities in *EAS* of 28 December 2004, *SWI* 2005, p. 358.

A, B or D in the example), even if they cannot be taxed in the state to which they are attributed. However, while the allocation will be used for the purposes of determining the part of the income for which the residence state is obliged to give a credit, it will not serve to restrict the taxation rights of that state (except if such a restriction results from the fact that relief from double taxation is provided through the exemption method).

The 2004 Report stipulates that, for purposes of the allocation rule, the only days of employment that should be taken into account are those that are relevant for the stock option plan, e.g. the days on which services are rendered to the same employer or to other employers and which would be taken into account to satisfy a period of employment required in order to irrevocably acquire the option. This is illustrated by the following example:

Example 5¹⁰²

Employee E is a resident of and is working in State A on 1 January 1998. He is granted an option to purchase shares for a price of 1, conditional on remaining in that employment until at least 1 January 2001. On 31 December 1999 he moves to work in State B, of which he becomes a resident. He exercises the option on 1 July 2001, when the market value of the shares acquired is 8, and immediately sells all the shares acquired. The benefit from the stock option should be regarded as income from employment covered by Art. 15.

Resides in State A		Resides in State B			
Works in State A		Works in State B			
1998	1999	2000	2001	2002	2003
↓ Grant			↓ Vesting		↓ Exercise

State A may tax the part of the stock option benefit that was derived from employment carried out there, but only as a proportion of the days that were relevant for the stock option plan. If each working year comprises 260 days, the total number of days relevant to the stock option plan amounts to 780 (3 × 260). State A may tax 520 (2 × 260) of these days on the basis that the stock option benefits are derived from employment carried on there and State B may tax 260 days on the basis that the stock option benefits are derived from employment exercised in State B. The remaining 130 days of employment between the date of vesting and exercise are not relevant to the stock option plan and are, therefore, ignored.

Example 6¹⁰³

Employee E is resident and working in State A on 1 January 1998. He is granted an option to purchase shares for a price of 1, conditional on remaining in that employment until at least 1 January 2001. On 31 December 1999 he moves in order to work in State B. Due to illness, his employment is terminated on 30 June 2000, but he is allowed to keep the option. He actually exercises it on 1 January 2001, when the market value is 7.

Resides in State A		Resides in State B			
Works in State A		Works in State B			
1998	1999	2000	2001	2002	2003
↓ Grant			↓ Vesting & Exercise		

If each working year is 260 days, the days relevant to the stock option plan will total only 650 (2½ × 260), and this will be the entire period of the employment. State A may tax 520 (2 × 260) days of this total of 650 since they derive from employment carried on in State A, i.e. 80%.

Lastly, the 2004 Report stipulates that states are free to agree bilaterally to adopt other approaches for determining whether and to what extent a particular employee stock option is derived from employment services rendered in a particular state, bearing in mind that such deviations may create difficulties in situations involving other states.

3.4. Analysis of the approach in the 2004 Report

3.4.1. Options granted for past or for future services

Based on the approach adopted in the 2004 Report one may assume as a general rule that (i) options are generally remuneration for future services and (ii) the period between grant and vesting is relevant for the allocation of taxation rights. Once an option cannot be taken away from the employee (generally the date of vesting), the employee may be considered to have obtained the benefit and can in fact realize the option at any time.

In brief, the principles applied by the 2004 Report in respect of employee options are as follows:

- stock options that may be exercised (“vested”) immediately constitute remuneration for the past;
- stock options that are vested (either in whole or in part) over a period of time – in the sense that they are subject to a condition precedent (i.e. the options may only be exercised if a certain period has elapsed and the person to whom the option is granted is still an employee of the company and/or combined with other conditions, such as profit targets to be reached by the employer-company) constitute remuneration for future services relating to the period between the grant and vesting of the option;
- stock options that are vested immediately, but are subject to certain conditions precedent (e.g. the option right will be forfeited if the employment relationship is terminated or profit targets are not met) constitute remuneration for the past because the employee has already obtained the benefit and can realize it at any time; and
- stock options that are granted unconditionally, but are not exercisable until a future date (“vesting over time”) also constitute remuneration for past services.

It is important to note that stock option agreements can include factors that would suggest that the reward relates both to past services and future services. For example, a stock option agreement may state that the options are exercisable immediately, but are subject to a penalty clause under which the employee must repay all or part

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 102. Para. 33 of the 2004 Report.
 103. Para. 35 of the 2004 Report.

of the benefit to the employer if the employee terminates the employment contract before a certain date.¹⁰⁴

An interesting point in this respect is the 2004 Report's view on options that can be immediately exercised on the grant date, but which are granted at a price substantially "out of the money". For example, an employer grants an option to an employee that is immediately exercisable at a strike price of 120, while the price of the underlying share on the granting date is 100. The "out of the money" element could be seen as an indication that the option is remuneration for future services. The revised Discussion Draft preceding the 2004 Report, however, took the view that this indication should be ignored.¹⁰⁵

It is remarkable that the 2004 Report (implicitly) uses the disposition theory – as discussed above – as the underlying theory for allocating the option benefits to the different periods of services, but rejects this theory for the purposes of determining the demarcation between Art. 13 and Art. 15. In the authors' view, it would have been more consistent to use the disposition theory as the basis in both cases.

3.4.2. Options granted for services provided in more than one state

The allocation rule proposed by the 2004 Report assumes a *pro rata temporis* increase in the value of the stock options. The 2004 Report does not give attention to the principle of allocating the taxation rights based on the change in the value of the option between the time the employee arrives in and the time he leaves a state. This method of allocation only measures the extent to which the employment services provided in each state have contributed to the right to exercise the option rather than measuring changes in the value of the option over specific periods of time. The main reason for this is that any method based on the value of the option is considered impractical and carries the risk of over-taxation in the event of a decrease in the value of the option. The authors note that the allocation rules will not be sufficient to avoid the double taxation that results from timing mismatches in the taxation of stock options by different states of residence, and this is also recognized by the 2004 Report.

4. Capita Selecta

4.1. Multiple residence taxation

The 2004 Report includes a chapter on multiple residence issues. While most of the 2004 Report deals with residence-source issues, situations of double taxation may also arise if an employee resides in different countries at the time an option is granted, vested, exercised or the underlying shares are sold. All these countries may claim the right to tax the options and if each state has a system that taxes the benefit at the time the taxpayer is a resident of that state, multiple residence taxation will occur for which only a mutual agreement procedure can provide a solution. Indeed, the 2004 Report suggests

using the mutual agreement procedure in cases of multiple residence taxation such as described above and proposes including this suggestion in the Commentary on Art. 23A and Art. 23B of the OECD Model.¹⁰⁶ Furthermore, the 2004 Report proposes as a solution for these situations that the authorities of the states involved agree that each state should provide relief as regards the residence-based tax that was levied by the other state on the part of the benefit that relates to services rendered during the period while the employee was a resident of that other state.

4.2. Options as part of a severance payment

If the employment of an international operative employee has been terminated, the treatment of options in the framework of that termination may, in practice, be an issue.¹⁰⁷ The question then arises as to whether the options have to be regarded as constituting a part of the severance payment or whether they have to be viewed as regular stock option benefits. This distinction may be of importance under the domestic law system of a given jurisdiction because they either tax severance payments differently from stock option benefits or follow different allocation rules for severance payments in comparison with stock option benefits. The latter category, which is particularly relevant for this article, occurs, for instance, in the Netherlands. The Netherlands Supreme Court held in its decisions of 11 June 2004, *BNB 2004/344* and *345* that a severance payment should be allocated on the basis of the individual's history of performing labour activities. In cases where the employee performed activities in different states, such an allocation may give rise, in the Court's view, to practical difficulties, and it may, therefore, be problematic to establish the required connection between the severance payment and the services performed in different states in the past. Therefore, the Court suggested formulating a limited reference basis in order to allocate these severance payments. Hence, if the employment is terminated and the employee was granted conditional stock options to which he remains entitled after the termination of the employment relationship, it could be established that a part of the stock option benefits do not relate to concretely rendered services, but instead have to be regarded as a severance

104. It is not uncommon for options that are immediately exercisable to be subject to a penalty clause that "mirrors" a vesting scheme (e.g. if options are to be vested in four instalments of 25% each, the penalty clause would stipulate that a penalty in the amount of 100% of the gain realized upon the exercise of an option would become due if the employee were to leave the company within one year of the option being granted. This penalty would be reduced by 25% on each subsequent anniversary). As a result, there is no economic difference between a plan with a vesting scheme and a plan that mirrors such a vesting scheme in a penalty clause.

105. P. 8, Para. 39, of the revised Discussion Draft, entitled "Cross-border Income Tax Issues Arising from Employee Stock Option Plans", (Paris: OECD, 2003).

106. See Para. 26 of the 2004 Report and Para. 4.1-4.3 of the 2005 Commentary on Art. 23A and 23B of the OECD Model.

107. This will normally be an issue if the options would have lapsed upon termination of the employment, but it is agreed between the employee and the employer that the clause in the option agreement pursuant to which the options lapse is no longer binding. See Burgstaller, *Schriftenreihe zum Internationalen Steuerrecht* (ed. M. Lang), op. cit., p. 98.

payment to which the above-mentioned allocation rules apply.

4.3. An illustration of allocation difficulties

Based on the case law of the German Federal Tax Court, non-tradable stock options are taxable, from a German perspective, at the moment at which they are exercised.¹⁰⁸ According to the Federal Tax Court, the options are granted in respect of future services to be performed by the participating employees. The gain on exercise must be allocated to the different states in which the employee performed services. The decisions of the German Federal Tax Court of 24 January 2001, *BStBl.* 2001 II, p. 509, and *BStBl.* 2001 II, p. 512 show that the Court wished to make the appropriate allocation of the stock option benefits based upon the period between grant and exercise;¹⁰⁹ in their Resolution of 14 September 2006, the German tax authorities allocate the benefits derived from certain stock options (non-tradable stock options and tradable stock options that are conditionally granted, i.e. subject to a blocking period) in proportion to the services rendered in the period between grant and vesting.¹¹⁰ This allocation must take place on a pro rata basis, unless, for instance, two employments exist (one with a German GmbH and one with a company residing in another state) and it follows from the facts and circumstances of the case (e.g. a contract) that employments have different remuneration packages (this also includes options being granted on a different basis).¹¹¹ The basis for this allocation is the place where the employee exercised his employment. According to the 1992-2005 Commentary on Art. 15 of the OECD Model, an employment is deemed to be exercised at the place where the employee is physically present when performing the activities for which he is paid. The allocation of the benefit will, in most cases, be made on the basis of the days the employee was physically present in the other state and in Germany.¹¹² The circumstance that the German case law uses a period for allocating the stock option benefits that may deviate from the 2004 Report and from the 2005 OECD Commentary may give rise to difficulties, e.g. a taxpayer could rely on the above-mentioned decisions of the German Federal Tax Court so that a situation of double non-taxation would arise.¹¹³ According to the German tax authorities, such difficulties had to be resolved through the mutual agreement procedure.¹¹⁴ Although the authors prefer the period suggested by the 2004 Report and the 2005 Commentary for allocating the stock option benefits, they endorse the part of the analysis of the German Ministry of Finance to the effect that differing views between the work state and the residence state with respect to this allocation period have to be resolved through the mutual agreement procedure. The 2000-2005 Commentaries on Art. 23 of the OECD Model do not resolve these issues given the factual character of these issues.

5. Conclusions and Suggestions

The authors welcome the fact that the OECD Commentary deals with employee stock options in cross-border

situations and, more particularly, the delineation between Art. 13 and Art. 15 of the OECD Model. Apart from the fact that the 2004 Report does not clearly define whether delineation issues between Art. 13 and Art. 15 with respect to employee stock options have to be regarded as interpretation or qualification conflicts, the moment at which the employee stock options leave the sphere of Art. 15 of the OECD Model (according to the OECD Commentary) and begin to fall under Art. 13 of the OECD Model (because they are exercised, sold or otherwise alienated) is open to criticism. The authors believe that this moment should be set at vesting because as of that moment the employee actually disposes of the employee stock options and the causality with the employment ends. Furthermore, this would be consistent with the allocation of the stock option benefits since

108. In the same sense the Resolution of the German tax authorities of 14 September 2006, point 6.6.2 and the Ministry of Finance of Nordrhein-Westfalen of 27 March 2003, BB 2003, No. 21, p. 1095 (with which the Federal Ministry of Finance explicitly agreed). According to the Resolution of 14 September 2006, in addition to non-tradable stock options, tradable stock options that are subject to a blocking period are taxable when exercised.

109. See R. Portner, Besteuerung von Stock Options bei internationalen mobilen Mitarbeitern – Kernaussagen des OECD-Papieres "Cross-border income tax issues arising from employee stock option plans", *IStR* 2005, No. 1, p. 10 (in Besteuerung von Stock Options im internationalen Kontext, *IWB* 2002, No. 19, p. 972, the same author assumed that the cases ruled on by the Federal Tax Court did not consider the issue of which period should be taken into account when allocating the stock option benefits since the option in those cases was exercised on the same day as it became exercisable); R. Pätzler, Zum Seminar F: Das OECD-Diskussionspapier zur Beseitigung der Doppelbesteuerung von Stock Options beim Arbeitnehmer, *Internationales Steuerrecht*, 2002, No. 16, p. 557, and M. Guenel and C. Hagen, The Taxation of Stock Options in Germany in the Light of the New Jurisprudence of the Federal Tax Supreme Court, *Intertax*, 2002/3, pp.101-106. The French Lower Administrative Court of Versailles, in its decision of 18 December 2001, *Copson*, *RJF*, 6/02, No. 690, has adopted a similar approach.

110. See resolution of the Ministry of Finance of Nordrhein-Westfalen of 27 March 2003, BB 2003, No. 21, p. 1095, with which the Federal Ministry of Finance agreed (this resolution is discussed by W. Neyer, Optionbesteuerung im internationalen Konzern, *IWB* 2004, No. 14, pp. 673-684 and by C. Dietborn and O. Strnad, Besteuerung von Aktienoptionen nach dem Erlass des Finanzministeriums NRW vom 27.3.2003 – erste Würdigung, BB 2003, No. 21, p. 1094-1095).

111. This can also be inferred from the decision of the Netherlands Supreme Court of 25 September 1996, *BNB* 1996/376.

112. The 2004 Report (Para. 34) and the Commentary (Para. 12.14 of the 2005 Commentary on Art. 15 of the OECD Model) state that the employment benefit attributable to a stock option has to be allocated to services performed in a particular country in the proportion of the number of days during which the employment has been exercised in that country to the total number of days during which the employment services from which the stock option is derived have been exercised. For that purpose, the only days of employment that should be taken into account are those that are relevant for the stock option plan, e.g. those during which services are rendered to the same employer or to the other employers and which employment would be taken into account to satisfy a period of employment required for the irrevocable acquisition of the option.

The authors note that a similar view seems to follow from the Netherlands Finance Ministry's Decree of 11 February 2002 and the decision of the Court of Appeals of The Hague of 3 July 2002, *V-N* 2002/42.1.12 (the taxpayer refers to the number of days on which he worked in the Netherlands, but this is not reflected in the calculations used by the Court of Appeals). The German Federal Tax Court did not rule explicitly on this point in its decisions of 24 January 2001. The Federal Tax Court referred the decisions on these issues to other lower courts for further investigation. In their Resolution of 14 September 2006, point 6.6., the German tax authorities also seem to endorse the approach of the OECD Commentary and the OECD Report.

113. See also Röpke and Schmidt, *op. cit.*, p. 61.

114. See the resolution of the Ministry of Finance of Nordrhein-Westfalen of 27 March 2003, BB 2003, No. 21, p. 1095, to which the Federal Ministry of Finance agreed. See also Neyer, *IWB* 2004, *op. cit.*, p. 683.

these benefits are generally allocated to the services rendered in the period between granting and vesting. The authors would prefer that the Commentary be amended accordingly (see below).

The 2004 Report's proposals and the implementation thereof in the 2005 Commentary on the OECD Model are a big step forward in the avoidance of double taxation of stock options in cross-border situations. These kinds of situations may also arise if the contracting states have different views as to how the stock option benefits have to be allocated to employments exercised in different states. Therefore, the 2004 Report and the 2005 Commentary on the OECD Model suggest that stock option benefits should generally be allocated by taking into account the services rendered during the period between grant and vesting. Depending on the facts and circumstances of a case, the allocation could be based on activities performed during another period if the stock option benefits, for instance, serve to remunerate the employment exercised during that period. The authors believe that the 2005 Commentary and the 2004 Report give a balanced solution for the allocation of stock option benefits.

Nevertheless, the OECD approach was not followed by the French Lower Administrative Court of Versailles in

the *Copson* case (allocation on the basis of the situation in the year of exercise) nor by the German Federal Tax Court (allocation of the stock option benefits in accordance with the services rendered in the period between grant and exercise). It remains to be seen how the changes made to the Commentary in response to the suggestions in the 2004 Report will be handled and whether the OECD approach will indeed be followed.¹¹⁵ The fact that various states employ divergent approaches to the attribution of stock option benefits may consequently cause difficulties. These difficulties may partly be resolved by including the relevant period for the attribution of the stock option benefit in a tax treaty provision (see also the 2001 UK-US tax treaty, which generally taxes stock option benefits when they are exercised).

Other difficulties may arise in cases of multiple residence, and these difficulties are also recognized in the 2004 Report. These issues should be resolved through the mutual agreement procedure or, preferably, by drafting tailor-made tax treaty provisions, in which peculiarities in domestic tax legislation that may affect the tax treaty at issue and problems caused by the emigration and immigration of employees to countries that tax options at different moments are, wherever possible, anticipated.

*Proposed amendments to the Commentary on Art. 15 of the OECD Model*¹¹⁶

12.2 While the Article applies to the employment benefit derived from a stock option granted to an employee regardless of when that benefit is taxed, there is a need to distinguish that employment benefit from the capital gain that may be derived from the alienation of shares acquired upon the exercise of the option. This Article, and not Article 13, will apply to any benefit derived from the option itself until it has been exercised, sold or otherwise alienated (e.g. upon cancellation or acquisition by the employer or issuer) vested, i.e. all the conditions necessary for the exercise of the option have been met and the right to exercise the option can no longer be forfeited, even if the option is only exercisable at a later date. Once the option is exercised or alienated has vested, however, the employment benefit has been realized because the option can be fully disposed of and any subsequent gain on the acquired shares (i.e. the value of the shares that accrues after exercise) will be derived by the employee in his capacity of investor-shareholder and will be covered by Article 13. After this moment the employee can freely decide whether or not he exercises the option, which is

an investment decision covered by Art. 13. Indeed, it is at the time of exercise vesting that the option, which is what the employee obtained from his employment, disappears and the recipient obtains or could obtain the status of shareholder (and usually invests money in order to do so). Where, however, the option that has been exercised entitles the employee to acquire shares that will not irrevocably vest until the end of a period of required employment, it will be appropriate to apply this Article to the increase in value, if any, until the end of the required period of employment that is subsequent to the exercise of the option.

12.3 The fact that the Article does not apply to a benefit derived after the exercise or alienation vesting of the option does not imply in any way that taxation of the employment income under domestic law must occur at the time of that exercise or alienation vesting. As already noted, the Article does not impose any restriction as to when the relevant income may be taxed by the state of source. Thus, the state of source could tax the relevant income at the time the option is granted, at the time the option is exercised, at the time the option has vested (or alienated), at the time the share is sold or at any other time. The state of source, however, may

115. This is the case for the UK HMRC and for the Belgian tax authorities. In their Circular of 25 May 2005, No. AFZ 2005/0652 (AFZ 08/2005), Annex I, the Belgian tax authorities to a large extent follow the 2004 Report and the 2005 Commentary.

116. Deletions are indicated by strike-out and insertions by underlining.

only tax the benefits attributable to the option itself and not what is attributable to the subsequent holding of shares acquired upon the ~~exercise vesting~~ of that option (~~except in the circumstances described in the last sentence of the preceding paragraph~~).

12.4 Since paragraph 1 must be interpreted to apply to any benefit derived from the option until it has ~~been exercised, sold or otherwise alienated~~ vested, it does not matter how such benefit, or any part thereof, is characterized for domestic tax purposes. As a result, whilst the Article will be interpreted to allow the state of source to tax the benefits accruing up to the time when the option has been ~~exercised, sold or otherwise~~

~~alienated~~ vested, it will be left to that state to decide how to tax such benefits, e.g. as either employment income or capital gain. If the state of source decides, for example, to impose a capital gains tax on the option when the employee ceases to be a resident of that country, that tax will be allowed under the Article. The same will be true in the state of residence. For example, while that state will have sole taxation right on the increase of value of the share obtained after ~~exercise~~ vesting since this will be considered to fall under Article 13 of the Convention, it may well decide to tax such increase as employment income rather than as a capital gain under its domestic law.

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