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Taxation of Compensatory Stock Options Under Tax Treaties

by Yuval Navot

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SPECIAL REPORTS

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I. Background

Income tax treaties may not help employees and directors avoid double taxation on their income from compensatory stock options unless additional arrangements between the contracting states are put in place. Double taxation on income from compensatory stock options imposes impediments on the mobility of human capital across countries. In limited circumstances, the absence of arrangements between contracting states may also result in double nontaxation. Similar to double taxation, double nontaxation also has an adverse effect on the proper allocation of human capital.

In this report, I discuss the reasons for double taxation and double nontaxation of income from compensatory stock options, and the various theoretical approaches to address it. I then describe and evaluate the arrangements used under the OECD model treaty and under several U.S. treaties.

II. Introduction

A. Double Taxation and Double Nontaxation

Double taxation and double nontaxation arise as a result of a combination of two elements: the tax treaty rules apportioning taxing jurisdiction over the income from compensatory stock options to both contracting states, and the inconsistency in the tax treatment of income from those options under the domestic laws of the contracting states. Each of these elements is further discussed below.

1. Apportionment of Taxing Jurisdiction

As opposed to a rule providing only one state the exclusive right of taxation, the allocation rules adopted by tax treaties allow both contracting states to tax the income from compensatory stock options.

Article 14(1) of the U.S. model tax treaty (income from employment), in combination with article 23 (relief from double taxation), grants the state in which the services are performed (the source state) a primary right of taxation over the income from employee stock options.[1] The state of the employee's residence (the residence state) has a secondary right of taxation — it can tax that income but must provide for relief from

[1]Unless otherwise indicated, references are to the 2006 U.S. model tax treaty, *available at* http://www.treas.gov/offices/tax-policy/library/model006.pdf, and all section references are to sections of the Internal Revenue Code of 1986, as amended, or Treasury regulations thereunder.

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double taxation. When the United States is the residence state, that relief is granted in the form of a foreign tax credit.

More technically, article 14(1) provides that remuneration derived by a resident of a contracting state as an employee may be taxed by the residence state and also by the source state. As a general principle, however, a residence state must grant tax relief for the source state's taxes whenever the source state may tax the income under the treaty. A special resourcing rule in article 23(3) ensures the application of that principle to U.S. residents. The rule, which applies solely for FTC purposes, deems the source of items of gross income derived by U.S. residents to be foreign if they may be taxed by the other contracting state under the treaty. The resourcing rule is important because the terms of the FTC relief that the United States must grant under a treaty are determined by those provisions and are subject to the limitations of U.S. domestic law.[2] Under the code, the FTC cannot exceed the amount of U.S. tax due on the net foreign-source income.[3] The resourcing rule therefore prevents the application of that limitation when income would otherwise be sourced within the United States.[4]

Article 14(2) excludes the source state's primary right of taxation if (1) the employee is present in the source state for a period or periods not exceeding 183 days in any 12-month period that begins or ends during the relevant tax year; (2) the remuneration is paid by or for an employer who is not a resident of the source state; and (3) the remuneration is not borne as a deductible expense by a permanent establishment that the employer has in the source state.

Article 15 (directors' fees), in combination with article 23, sets forth the apportionment rule for directors' remuneration. Under that rule, the source state has a primary right of taxation over a director's remuneration only if that state is also the residence state of the company paying the remuneration. The director's residence state has a secondary right of taxation — it can tax the income but must provide for relief from double taxation.[5]

The similarity between the apportionment rules of articles 14 and 15 is that both require services to be performed in the nonresidence state of the service provider for that state to have a primary right of taxation. In other words, both articles grant a primary right of taxation to the nonresidence state only if it is the source state. The difference between the two articles is that article 15 requires the nonresidence state, in addition to being the source state, to be the residence state of the company paying the director's compensation. Also, as opposed to article 14, article 15 does not have an exception for short-term presence in the source state.

The OECD model treaty's employment article is similar to that of the U.S. model treaty. However, there is a material difference in the directors' fee article. Under the OECD model treaty, the residence state of the company paying the director's remuneration has a primary right of taxation regardless of where the services are performed.[6] The OECD model treaty therefore eliminates the source requirement that is present in the U.S. model treaty.[7]

2. Treatment of Compensatory Stock Options

The second element leading to double taxation and double nontaxation is the inconsistency in the tax treatment of compensatory stock options between the two contracting states. The inconsistency results because the domestic laws of each contracting state often vary in the way they tax compensatory stock options. It is possible to identify three elements that together shape the tax regime of employee stock options under domestic laws. These are the timing of the tax event (for example, the grant date, the vesting date, the exercise date, or the date of disposition of the underlying shares); the character of the income (ordinary income or capital gains); and the source of the income. As further discussed below, the source of the income is basically a function of the period of work that the option

[2] *See* article 23(2).

[3] Section 904(a).

[4] The application of this principle to residents of the U.S. counterparty's state is not apparent from the U.S. model treaty because the model leaves the tax relief arrangements of that state blank. This is because those arrangements are to be determined by that contracting state. However, assuming the tax relief arrangements of that counterparty state are based on the OECD model treaty, it is clear that, as a residence state, it must grant tax relief for U.S. taxes whenever the United States may tax the income under the treaty. Both articles 23A(1) and 23B(1) of the OECD model treaty state that the residence state will provide tax relief to its residents when the other contracting state may tax that income in accordance with the provisions of the treaty.

[5] More technically, article 15 provides that a state may tax the fees and other compensation paid by a resident company for services performed in that state by a resident of the other contracting state in his capacity as a director of the company. As noted above, whenever a state may tax income of a taxpayer under the treaty, the taxpayer's residence state must grant relief from double taxation regarding that income.

[6] Article 16 of the OECD model treaty.

[7] Section 1 of the OECD commentary to article 16 explains the elimination of the source requirement as follows: ''Since it might sometimes be difficult to ascertain where the services are performed, the provision treats the services as performed in the State of residence of the company.''

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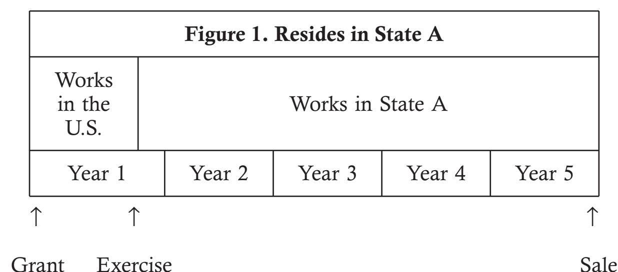
compensates and of the method for determining the income accrued during that period. In a perfect tax system, all three elements would be conceptually interrelated. The timing of the tax event should determine the dividing line between ordinary income and capital gains — income attributable to the period ending on the date of the tax event should be treated as ordinary, while income attributable to any subsequent period should be treated as capital gains. Similarly, the source of the income should be based on the period of work that the options compensate, and that period should end on the date on which the tax event occurs.

Double taxation or double nontaxation can arise when there is a difference in one or more of these elements between the two contracting states, that is, inconsistency in the timing of the income recognition event, in the character of the income recognized, or in the source of the income. The following are a few examples illustrating these situations.[8]

a. Timing mismatch. The following two examples demonstrate double taxation arising from a mismatch between the two contracting states on the timing of the tax event. Timing mismatch can also arise from a deemed realization of the options in one state but not in the other. A deemed realization event arises, for example, as a result of a merger in which options in the target are exchanged for options in the acquiring corporation (or its affiliate) or as a result of a change of substantial terms of the options. In Example 1 below, the mismatch causes a source conflict between the two contracting states, while in Example 2 the mismatch causes a residence conflict.

Example 1 (source conflict): An employee resident of State A works for a U.S. company for eight months and receives incentive stock options as compensation for his work in the United States (the options are granted when the employee moves to the United States and are vested when the U.S. work is complete). The United States taxes the income from the options when the employee sells the shares received from the options (the amount of taxable income is equal to the value of the shares on the disposition date minus the exercise price),[9] and State A taxes the income on exercise of the options into shares (in an amount equal to the fair market value of the shares on the exercise date minus the exercise price). The employee exercises his options after eight months and sells the shares received in year 5. The employee is taxed in State A in year 1 and in the United States in year 5. Double taxation might arise if State A is unwilling to grant tax relief for the U.S. taxes based on an argument that the U.S taxes relate to a different tax event. Even if State A is willing to grant tax relief, for example, in the form of an FTC for the U.S. taxes paid on the income in year 5, it may be possible that the FTC cannot be carried back to year 1 because of carryback limitations or because the year to which the credits are intended to be carried back is already closed. This situation might also result in both countries claiming source taxing rights for income attributable to the period between the exercise date and the disposition date of the shares. (See Figure 1.)



Example 2 (residence conflict): Another example of double taxation resulting from a mismatch in the timing of the tax event involves multiple residence countries. As illustrated in this example, the reason for the timing mismatch is that each contracting state considers itself a residence state based on the date of the tax event under its own domestic laws, and those dates do not correspond. Article 23, which deals with residence-source conflicts, is generally unhelpful in providing relief for residence-residence conflicts.

The example is as follows: Employee resident in State A receives nonqualified options with a three-year vesting period. During the first year he works 50 days in State B and the rest in State A. At the end of year 1, the employee relocates to the United States, becomes a U.S. resident, and works in the United States until the end of year 3. The employee exercises the options at the end of year 3. State A taxes the employment benefit at grant, while the U.S. taxes it on exercise.[10] State B does not have a right to tax the income under article 14(2) of State A-State B treaty (discussed above) because the employee worked in State B for less than 183 days. The income attributable to State B is therefore subject to tax in both State A and the United States, while no country will be willing to grant a credit for the tax paid to the other contracting state because neither State A nor the United States is a source state.[11] The conflict of residency cannot be resolved under the tiebreaker rules of article 4(2) because

[8]In all examples, "residency" refers to the residency as determined for tax treaty purposes.

[9]Section 421(a).

[10]Section 83(e)(3) and reg. section 1.83-7(a).

[11]Double taxation can arise even if the employee is present in State B (a third source country) for more than 183 days and State B's source taxing right is therefore not limited by article

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each contracting state determines residency for purposes of applying the treaty at a different point in time. (See Figure 2.)

Figure 2		
Resides in State A	**Resides in the U.S.**	
Works in State A (and 50 days in State B)	Works in the U.S.	
Year 1	Year 2	Year 3

↑ Grant ↑ Exercise

b. Character mismatch. The following example demonstrates double taxation arising from a mismatch between the two contracting states in the character of the income that is recognized from compensatory stock options.

Example 3 (character mismatch): An employee resident of State A works in the United States for a U.S. company for eight months and receives options for his work (the options are granted when the employee moves to the United States and are vested when the U.S. work is complete). The employee then sells the options and returns to State A. The U.S. taxes the income from the options when the employee sells the options as income from employment.[12] Article 14 grants the United States a primary right of taxation over the income. State A, however, taxes the income as employment income on grant, and any subsequent appreciation is considered capital gains. Article 13(2) grants State A an exclusive right of taxation regarding those capital gains because the employee is a resident of State A. Therefore, each contracting state can claim primary right of taxation over the income accrued from grant to exercise based on the application of the-treaty, and there is no clear mechanism to alleviate the potential double tax. (See Figure 3.)

Figure 3. Resides in State A	
Works in the U.S.	
Year 1	

↑ Grant ↑ Sale

c. Source mismatch. The following examples demonstrate double taxation and double nontaxation arising from a source mismatch between the two contracting states regarding the income that is recognized from the options. The mismatch can arise from inconsistent positions relating to the period of work to which the options relate (as illustrated in Example 4), or from inconsistent positions relating to the method of determining the income from the options that arises during a given period of work (as illustrated in Example 5).[13]

Example 4 (mismatch in the period of work):[14] An employee resident of State A receives options and immediately relocates to the United States, where he works during the entire vesting period. The employee also exercises the options at the end of the vesting period while living in the United States. State A treats the options as compensating employment for the period starting one year before the grant date and ending on the vesting date, while the United States treats the options as compensating employment during the vesting period only. As a result, both the United States and State A may claim primary right of taxation on 20 percent of the income (one year out of the four that State A considers the work period). (See Figure 4.)

Example 5 (income measurement mismatch): Double taxation or double nontaxation can arise even if the contracting states are consistent in their treatment of the period of work that the options compensate. For example, an employee resident of State A receives options with a four-year vesting period. The employee works two years in State A and then relocates to the United States, where he works for an additional two years, after which he exercises the options.

14(2). In that case, double taxation can arise regarding the income attributable to the services performed in State B if both State A and the United States are credit countries and the tax paid to each of those states on the income attributable to State B exceeds the tax paid to State B. The amount of double taxation will be equal to the overlap in the amount of taxes paid to State A and to the United States that is in excess of the amount of tax paid to State B. To illustrate, if the tax paid to State B is $60 and the tax paid to the United States and State A on the income attributable to the services performed in State B is $65 and $68, respectively, the double tax will be $5 (the overlap between the tax after credit paid to State A which is $8 and the tax after credit paid to the United States which is $5).

[12]Section 83(e)(3) and reg. section 1.83-7(a).

[13]Similar double tax concerns arise in the context of interstate relocations within the United States. *See* Thomas Cryan Jr. and Garrett Fenton, ''Herding Cats: The Muddled State of State Income Tax Withholding For Income Earned by Nonresidents From the Exercise of Stock Options,'' 58 *DTR* J-1 (Mar. 30, 2009).

[14]This used to be a conflict between the United States and Canada. *See* Sanford H. Goldberg et al., ''Taxation Caused By or After a Change in Residence (Part II),'' *Tax Notes Int'l*, Aug. 14, 2000, p. 741, *Doc 2000-21275*, or *2000 WTD 157-15*.

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Figure 4			
Resides in State A	Resides in the U.S.		
Works in State A	Works in the U.S.		
Year 1	Year 2	Year 3	Year 4

↑ Grant (start of Year 2) ↑ Vesting + Exercise (end of Year 4)

Both State A and the United States treat the stock options as compensating work performed during the vesting period. However, State A determines the income allocated to the two-year work period in State A based on the value of the options at the end of year 2, while the United States uses a pro rata time-based allocation. Any excess of the income sourced in State A under its domestic laws over the income sourced in State A under U.S. tax law may be subject to potential double taxation (and any deficit is subject to potential double nontaxation). (See Figure 5.)

Figure 5			
Resides in State A		Resides in the U.S.	
Works in State A		Works in the U.S.	
Year 1	Year 2	Year 3	Year 4

↑ Grant (start of Year 1) ↑ Vesting + Exercise (end of Year 4)

B. Elimination of Double Taxation, Nontaxation

As discussed above, the two elements that cause double taxation and double nontaxation of income from compensatory stock options are the treaty apportionment rules that grant taxing rights to both contracting states over the income, and the inconsistent tax treatment of that income under the domestic laws of the two contracting states. Elimination of one of these elements, either by modifying the treaty apportionment rules to grant an exclusive right of taxation to only one state or by modifying the domestic laws of the contracting states to be consistent, will prevent double taxation and, in many cases, double nontaxation. Another approach to eliminate double taxation and double nontaxation is to agree on a consistent tax treatment of compensatory stock options solely for purposes of the treaty. Each of these approaches is discussed further below.

1. Modification of Domestic Laws of Contracting States

Modifying the two contracting states' domestic laws to create consistency in the tax treatment of compensatory stock options is probably an impractical measure. It requires the two states to agree on the tax regime for compensatory stock options. That regime often involves general tax concepts and principles that are inherent to each state's tax system. Also, for this approach to work, the tax regime would have to be conformed to by all treaty counterparties to these two states, and then by states that have treaties with those counterparties, and so on. In effect, therefore, this solution requires all states to modify their internal laws to conform to an agreed tax regime for compensatory stock options.

2. Modification of Treaty Apportionment Rules

Modifying outstanding treaties' apportionment rules to grant only one of the two contracting states an exclusive right of taxation over income from stock options might also be a hard measure to implement, as it requires opening existing treaties. It might, however, be simpler to implement in new treaties. Having an exclusive right of taxation instead of apportionment rules that grant taxing rights to the two contracting states will prevent double taxation because only one state will be entitled to tax the income from the options. Double nontaxation, however, can still arise to the extent that the state with the exclusive right of taxation does not exercise that right.

There are various criteria on which an exclusive right of taxation can be based, such as the residency of the taxpayer as of an agreed date during the life of the option, the source of the income, the principal place of the business of the company granting the options, or a combination of these criteria, for example, through an ordering rule.

A residence-based criterion is the only criterion for an exclusive right of taxation that promotes capital export neutrality. Capital export neutrality requires that a resident of a given state pay the same marginal tax rate on income regardless of its source, the rationale being that this will create worldwide economic efficiency because investments will not be affected by tax considerations. The U.S. international tax system, particularly the relief granted to foreign taxes in the form of credits, is generally based on this principle.[15] Further, a residence-based rule is consistent with a progressive

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[15]*See* Michael J. Graetz, ''The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies,'' 54 *Tax L. Rev.* 261, 273-274 (2001). However, some features of the U.S. international tax system, such as no current taxation on active income of U.S. controlled corporations, are more consistent with capital import neutrality, discussed in the main text. *See also* Joint Committee

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income tax system applicable to individuals, which is a principal goal of virtually all income tax systems, including the U.S. system. Therefore, to the extent an exclusive right of taxation is to be adopted, the residence-based criterion seems to be the most appropriate for the U.S. tax system. Finally, an exclusive residence-based right of taxation will equate the tax rates applicable to income from compensatory stock options with the rates applicable to other forms of remuneration for services, provided the source-state marginal tax rate is lower than the residence-state marginal tax rate. This is because the treaty apportionment rule applicable to remuneration for services generally grants a residual right of taxation to the residence state.[16] If, however, the source-state marginal tax rate is greater than the residence-state marginal tax rate, other forms of remuneration for services will be subject to a higher tax rate compared with the rate applicable to income from stock options.[17]

Adopting a residence-based apportionment rule for income from compensatory stock options may raise fiscal concerns for the contracting states. Granting an exclusive right of taxation to the residence state means that the source state cannot tax the income. This fiscal concern is understandable, given the technical nature of a residence-based rule, which is relatively easy to manipulate.

Also, a residence-based rule is a deviation from the normal apportionment standard applicable to services, which is based on the place of performance of the services. The place of performance standard is intended to grant a primary right of taxation to the country where economic activity generated the income.[18] The location of the activity that generates the income from compensatory stock options is not necessarily aligned with the residence state as of a particular date during the life of the option. Therefore, eliminating the right of taxation of the state in which services were performed conflicts with the objective of the apportionment rule, which is to grant a primary source-based right of taxation.[19]

Finally, a residence-based exclusive right of taxation requires pinpointing when, over the life of the option, residence is relevant. This is necessary to avoid the conflict, illustrated in Example 2 above, regarding the point at which residency is determined. In determining that point, there may be conflicting considerations. Under general tax principles, that point should be the date on which the income from the options is realized, which is normally the vesting date. However, that date does not always correspond to a point at which the income can be easily assessed.

A source-based criterion is the only criterion for an exclusive right of taxation that results in capital import neutrality. Capital import neutrality requires that the same marginal tax rate be paid on income earned in a given country regardless of the taxpayer's residence; it results in all taxpayers located in a particular jurisdiction being subject to the same tax rates.[20]

Implementing a sourced-based apportionment rule requires adopting an elaborate set of rules to determine where income is sourced. As discussed above, the answer to the question of where income is sourced depends on the period of work that the options are viewed as compensating and on the method of apportioning source between two countries in multiple source situations. Accordingly, rules will have to be developed to address these issues.

An exclusive source-based right of taxation results in the grant of an exclusive right of taxation to two states in multiple source situations (in which both contracting states are source states for different portions of

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on Taxation, ''Study of the Overall State of the Federal Tax System and Recommendations for Simplification,'' JCS-3-01 (Apr. 2001), 390-391.

[16]*See* the discussion in Part II.A.1 above.

[17]This is because income from options will be subject only to the residence state tax rate as opposed to the other forms of remuneration that will be subject to the higher source state tax rate. It is assumed that excess credits generated because of the excess source state's taxes over residence state's taxes cannot be used by the taxpayer.

[18]In the context of domestic source rules, which are in many aspects equivalent to the treaties' apportionment rules, the JCT noted:

> Present law generally treats income as having a U.S. source when a reasonable economic nexus exists with the United States. For example, in the case of active business or service income, the location of the relevant economic activity generally determines nexus.

See JCT study, *supra* note 15, at 393. The place of performance standard might also be explained as serving the purpose of granting source taxing rights to the country or countries that provided the taxpayer with government benefits, such as the physical, legal, and economic infrastructure. For a discussion and criticism of this ''benefits theory,'' see American Law Institute,

(Footnote continued in next column.)

''Federal Income Tax Project: International Aspects of United States Income Taxation (Proposals of the American Law Institute on United States Taxation of Foreign Persons and the Foreign Income of United States Persons)'' (1987), 18-19; and Stephen E. Shay, J. Clifton Jr., and Robert J. Peroni, ''The David R. Tillinghast Lecture: What's Source Got to Do With It? Source Rules and U.S. International Taxation,'' 56 *Tax L. Rev.* 81, 90-91 (2002).

[19]It may be argued, however, that the value of the underlying shares and some macroeconomic parameters determine the value of the options and not the activities of a service provider in a particular location. Therefore, under this argument, the activities generating the income are not necessarily performed in the state in which the service provider worked. This argument incorrectly looks at the location of the activities that generated the compensation for the work and not the location of the work that generated the compensation.

[20]For a discussion on capital import neutrality and its premise, see Graetz, *supra* note 15, at 270-271.

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the income) and in double nontaxation by the two contracting states if income is sourced in a third state.[21] As discussed above, this rule is inconsistent with the progressive nature of a typical income tax system. Also, it may result in different tax rates applying to income from options than from other forms of remuneration for services because of the difference in the treaty apportionment rules (an exclusive source tax in the case of options, and a residual residence tax in the case of other forms of remuneration for services). That difference in the tax rates will arise when the source state's marginal tax rate (applicable to income from options) is lower than the residence state's marginal tax rate (applicable to other forms of remuneration).

3. Consistency for Treaty Purposes

An alternative approach to eliminate double taxation and double nontaxation of income from compensatory stock options is to create consistency between the two contracting states solely for the purpose of applying the treaty. That consistency is achieved by setting forth agreed standards for the principal elements that shape the tax regime of compensatory stock options, which (as discussed above) are the timing of the tax event, the character of the income, and its source. In effect, these standards create a fictional tax regime solely for purposes of the treaty, and the treaty provisions are applied to income from the options based on that fictional tax regime. Under this approach, each contracting state may still tax the income from stock options in accordance with its own domestic laws despite the fictional tax regime adopted for purposes of the treaty. However, its taxing rights are subject to limitations imposed by the treaty. This approach was adopted by the OECD in the 2005 amendment to the commentary to its treaty model (OECD commentary). It is also the approach adopted in the three U.S. treaties that address the taxation of compensatory stock options (the treaties with Canada, Japan, and the United Kingdom). Both the OECD and U.S. approaches are discussed in detail below. The arrangements differ in the content of the agreed standards, but the concept of effectively creating an agreed tax regime solely for purposes of the treaty is the same.

In a sense, this approach of consistency for treaty purposes is simple to apply. It does not require a revision of the treaty apportionment rules applicable to income from stock options. Therefore, no change to treaties is required. Nor does it require that the two contracting states amend their domestic laws to create a consistent tax regime for compensatory stock options. However, as discussed below, the difficulties of this approach are in shaping the agreed on standards.

In a tax system free from nontax considerations, the timing of the tax event for income from compensatory stock options must be determined under general income realization principles. Under these principles, the tax event should occur on the vesting date.[22] Also, the other elements of the tax regime of compensatory stock options should be based on the vesting date being the income realization date so that (1) the character of income attributable to the period ending on the vesting date is services income and the character of the income attributable to any subsequent period is capital gains, and (2) the source of the income from services is based on the service provider's work performed during the period ending on the vesting date.

In practice, however, in many states the timing of the tax event is not the vesting date, but rather the exercise date or for some so-called qualified options (in the United States, the technical term is ''incentive stock options''), the date on which the shares received from the options are disposed of. Similarly, in many states the income as of the exercise date is characterized as services income even though it is partially attributed to a postvesting period, and the entire income from the disposition of shares received from qualified options is characterized as capital gains even though part of the income is attributable to work performed during the vesting period. Also, in some states the source of the income from options is not based on the period ending on the vesting date.

In the domestic context, when all the compensated work is performed in the same country where the employee and the option issuer are located, the fiscal effect of a deviation from the vesting date as the realization date is often offset to a large extent by a corresponding treatment of the options' issuer, and in any event, it is a result of the tax regime adopted by that country. For example, the loss of fiscal revenue resulting from the deferral of an employee's tax event from the vesting date to the exercise date is, in many cases, largely offset by the fiscal revenue from the corresponding deferral of the deduction of the options' issuer. Similarly, the characterization of the entire income from compensatory stock options as capital gains eligible for a reduced rate of taxation is often offset by the denial of a deduction to the options' issuer. In both examples, the fiscal effects of these rules to a particular state result from the compensatory stock options tax regime adopted by that state.[23]

However, in the cross-border context, when more than one state is involved, the deferral of the tax event

[21]The third state, however, may tax the income.

[22]If the options do not have any vesting restrictions, the vesting date is the grant date.

[23]It is easy to prove mathematically that the value of the deferral is equivalent to the value of investing the after-tax amount of the income over the period of the deferral at a pretax rate of return (assuming tax rates remain constant). In other words, it is as if the service provider that defers its income pays tax currently on the deferred amount but can then invest the after-tax proceeds

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in one state from the vesting date to the exercise or a later date, the treatment of post-vesting-date income as services income or the determination of source based on a period that ends before or after the vesting date may affect the allocation of taxing rights between states. In those situations, because more than one state is involved, the fiscal effect to a state of a particular tax rule applicable to the service provider is not necessarily offset by a rule applicable to the options' issuer. Moreover, a deviation from realization principles generally may reflect the tax policy of only one state but not the other state that might actually suffer an adverse fiscal effect. It therefore seems appropriate that the consistent tax regime for treaty purposes be based, to the extent practical, on general income realization principles and that the timing, character, and source of the income be based on the vesting date.

III. The OECD Approach

A. Summary of OECD Approach

1. General

In March 2002 the OECD Committee on Fiscal Affairs published a first public discussion draft on potential tax treaty issues arising from employee stock options, with proposals for addressing those issues. The discussion draft was revised in July 2003 to reflect comments received. The revised draft included proposals for changes in the OECD commentary. A final report was approved by the committee in June 2004 (the OECD report).[24] The report's recommendations are reflected in the 2005 amendments to the OECD commentary.

The OECD approach is to neither change the treaty apportionment rules applicable to income from compensatory stock options nor to require that the two contracting states amend their domestic laws to create a consistent tax regime for those options. Consistency is achieved through OECD commentary amendments that effectively create a fictional tax regime for compensatory stock options. The treaty provisions are applied to compensatory stock options based on that fictional tax regime. Each contracting state may still tax the income from the options in accordance with its domestic laws, subject to the limitations imposed by the treaty.

The fictional tax regime is based on agreed standards in two out of the three principal elements that shape the tax regime of compensatory stock options. It sets forth agreed to standards for the character and source of the income, but there is no agreed standard for the timing of the tax event.

2. Timing of Tax Event

The OECD commentary does not address the timing of the tax event. Instead, it provides ad hoc solutions for mismatches in the timing of the tax event. For example, the OECD commentary makes it clear that the residence state should grant double tax relief for any taxes paid to the source state regardless of time limits.[25] This is already the case under articles 23A and 23B of the OECD model treaty but not for countries, such as the United States, in which double tax relief is granted in accordance with domestic laws. Under the OECD commentary, those countries are expected to seek other ways to relieve double taxation (for example, by the mutual agreement procedure).[26]

As a result, in the case illustrated in Example 1, when the tax event in the residence state occurs on the exercise date and the tax event in the source state occurs on a later date when the shares received from the options are sold, the residence state must grant tax relief for any taxes paid to the source state even if those taxes were paid many years after the exercise date. Although not directly addressed in the OECD commentary, the tax relief to be granted by the residence state should reflect only the taxes attributable to periods ending on or before the date of the tax event in the residence state. Under the facts of Example 1, no double tax relief should be granted for income or taxes attributable to any period that is after the exercise date.

An ad hoc solution is also proposed to address the multiple residency situation illustrated in Example 2, in

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on a tax-exempt basis. *See* JCT, ''Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II,'' 7, JCX-63-07 (Sept. 2007), *Doc 2007-20256*, *2007 TNT 172-13*.

[24]The 2002 discussion draft is *available at* http://www.oecd.org/dataoecd/39/50/2069901.pdf. For a summary, see Catherine Bobbett and John F. Avery Jones, ''Tax Treaty Issues Relating to Cross-Border Employee Stock Options,'' 57 *Bull. for Int'l Fiscal Documentation* 4 (2003); and Perla Gyöngy Végh, ''OECD Faces Employee Stock Options,'' 42 *Eur. Tax'n* 265 (2002). The 2003 revised discussion draft is no longer available on the OECD Web site. The 2004 final report is *available at* http://www.oecd.org/dataoecd/35/53/33700277.pdf. The final report is also available in ''The Taxation Of Employee Stock Options,'' OECD Tax Policy Studies (No. 11, 2005), 83-114. For a comprehensive discussion of the OECD final report and the 2005 amendments to the OECD commentary, see Frank P.G. Pötgens and Marcel Jakobsen, ''Cross-Border Taxation of Employee Stock Options: How to Improve the OECD Commentary — Part 1,'' 47 *Eur. Tax'n* 407 (2007); Pötgens and Jakobsen, ''Cross-Border Taxation of Employee Stock Options: How to Improve the OECD Commentary — Part 2,'' 47 *Eur. Tax'n* 467 (2007); and Rosemarie Portner, ''OECD Approach to Cross-Border Stock Option Taxation: A German Perspective,'' *Tax Notes Int'l*, Nov. 29, 2004, p. 749, *Doc 2004-19068*, or *2004 WTD 231-13*.

[25]OECD commentary on articles 23A and 23B, para. 32.8.

[26]*Id.* at article 23(2), stating that FTCs will be granted to U.S. residents and citizens ''in accordance with the provisions and subject to the limitations of the law of the United States.'' Under section 904(c), unused FTCs can be carried back for 1 year and carried forward for 10 years.

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which a taxpayer is considered a dual resident of both contracting states because each state determines residency at a different time (the date of the tax event under its domestic laws). In this situation, neither contracting state is obligated to grant tax relief for taxes paid to the other contracting state on income sourced in a third state, because no contracting state is a source state. The OECD commentary proposes to use the mutual agreement procedure to deal with this situation. It further notes that one possible basis for an agreement between the component authorities of the two contracting states is that the contracting state required to grant the double tax relief (for the residence-based taxes imposed by the other contracting state on income sourced in a third state) would be the state in which the taxpayer was not a resident during the period in which it generated the income in the third source state.[27] Under the facts of Example 2, the United States must grant FTCs for taxes paid to State A on the income sourced in State B, because the employee was a resident of State A while working in State B.[28]

3. Character of Income

The OECD commentary states that income attributable to the period ending on the exercise date of the option or the date it is sold or otherwise alienated (for example, on cancellation or acquisition by the employer or the issuer) is income from the provision of services and therefore subject to article 15 (income from employment) or article 16 (directors' fees) of the OECD model treaty, as applicable. Any income attributable to a period beginning after that date is subject to article 13 (capital gains) of the OECD model treaty, except in the unusual case in which the shares received on exercise of the options are still subject to vesting restrictions.[29] The laconic explanation provided in the OECD report for the adoption of this dividing line is that this is the practice followed by many countries, it is practical, and it is right to treat an employee as an investor only from the time he becomes a shareholder and invests money to do so.[30]

The character of the income under the domestic laws of each contracting state is irrelevant to, and does not affect, the character of the income for treaty purposes. Thus, an employee's income attributable to the period ending on the exercise date will be treated as income from services subject to the apportionment rule of article 15 of the OECD model treaty even though the income is treated as capital gains under the domestic laws of both contracting states. As noted above, each contracting state may still tax the income under its domestic laws to the extent not limited by the treaty. For example, a source state may tax income from stock options as capital gains even though it has a primary right of taxation over that income under article 15 of the OECD model treaty. Similarly, a residence state that has an exclusive right of taxation over the gain attributable to the appreciation of shares following the exercise of options can tax the income as employment income under its domestic laws.[31]

4. Source of Income

The OECD commentary provides standards for both elements that determine the source of income from compensatory stock options: the period of work to which the options relate (the ''work period'') and the method for determining the income accrued during that period. It notes, however, that countries may reach bilateral arrangements that depart from these standards.[32]

The OECD commentary sets forth a facts and circumstances test to determine the work period.[33] It further provides that the work period must generally end on the vesting date or, more technically, on the date after which no employment is required as a condition

[27]OECD commentary on articles 23A and 23B, para. 4.3.

[28]This solution might be problematic if the taxpayer changed its residency during the period of work in the third state or became a resident of the third state. For a different method of allocating taxing rights between two residence states, see Bobbett and Avery Jones, *supra* note 24, at 7. Under that method, State A must grant FTCs in an amount equal to A/(A+B) * (the lesser of A or B), and State B must grant FTCs in an amount equal to B/(A+B) * (the lesser of A or B). For this purpose, A and B are the taxes paid in contracting State A and contracting State B, respectively (after credit for any taxes paid to noncontracting source states). The result of applying this method is that the combined amount of tax paid in States A and B cannot exceed the higher of the two taxes in States A and B, which is the usual result in a credit system.

[29]*See* OECD commentary on article 15, paras. 12.1-12.5; OECD commentary on article 16, para. 3.1; and OECD commentary on article 13, para. 32. Paragraph 12.5 of the OECD commentary on article 15 also states that an employee's income from stock options is subject to neither article 21 (other income), which applies only to income not covered by other articles, nor to article 18 (pensions), which applies only to pensions and other similar remuneration, even if the options are exercised after termination of the employment or retirement.

[30]OECD report, para. 23. *See* OECD commentary on article 15, para. 12.2 stating, ''indeed, it is at the time of exercise that the option, which is what the employee obtained from his employment, disappears and the recipient obtains the status of shareholder (and usually invests money in order to do so).'' For a similar statement, see the OECD commentary on article 16, para. 3.1.

[31]OECD commentary on article 15, para. 12.4. Also, the fact that the dividing line for treaty purposes between services income and capital gains is the exercise or alienation date does not imply that the contracting states must tax the employment income under their domestic laws at the time of exercise or alienation. *Id.* at para. 12.3.

[32]*Id.* at para. 12.15.

[33]*Id.* at para. 12.6.

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of exercising the options.[34] Some exceptions to this rule may apply. For example, the vesting date might not be the end of the work period if the shares received on exercise of the options are still subject to vesting restrictions or if the options relate to a future service (for example, options without vesting restrictions granted when an employee takes up employment, is transferred to a new country, or is given significant responsibilities and, in each case, the options clearly relate to the new functions to be performed by the employee during a specific future period).[35]

The OECD commentary further provides that the work period should start on the grant date unless the options relate to a service rendered in a specific period starting before the grant date (past services). Past services include options based on an employee's past performance during a specific period or options based on the employer's past financial results and conditioned on the employee having been employed by the employer or an affiliate during the period to which the financial results relate. They also include situations in which there is objective evidence demonstrating that during a period of past employment there was a well-founded expectation (for example, based on the employer's past practice) that part of the remuneration would be paid in the form of stock options.[36] The commentary also notes that in cases of doubt, it should be recognized that options are primarily related to services provided after their grant.[37]

As to the method of determining the amount of income accrued during the work period in cases where the work was performed in several source states, the OECD commentary provides a linear allocation rule. The rule is based on the proportion of the number of days during which employment was exercised in a particular state to the total number of days of employment during the work period.[38] Thus, for example, if an employee worked two years in the United States and two years in State A and the period of work to which the options relate is the period starting on the options' grant date and ending when they vest four years later, 50 percent of the income will be sourced in the United States and 50 percent will be sourced in State A. When stock options vest incrementally, for example, 25 percent per year over four years, the work period has to be determined separately for each vesting period. As a result, options granted on the same date but vesting on different dates will be sourced differently based on the percentage of time spent in a particular state during each separate vesting period. Assume, for example, that options granted at the beginning of year 1 vest incrementally at the end of each year over four years. During the four-year vesting period, an employee works for two years in the United States and then for two years in State A. The income from the tranches vested at the end of years 1 and 2 will be sourced in the United States, the income from the tranche vested in year 3 will be sourced 66.7 percent in the United States and 33.3 percent in State A, and the income from the tranche vested at the end of year 4 will be sourced 50 percent in the United States and 50 percent in State A.

As noted above, the OECD treaty apportionment rule for directors' income is based only on the residence state of the company in which the directors serve. The source of the income is irrelevant. Therefore, under the OECD model treaty, the issues resulting from source mismatches are inapplicable to options granted to directors in their capacity as such.[39]

B. Comments on OECD Approach

1. Conceptual Inconsistency

The OECD approach provides a solution that does not require any amendment of outstanding tax treaties or revision of domestic laws. This is achieved by effectively creating, through the OECD commentary, a fictional compensatory stock options tax regime to which the treaty is applied. It is therefore a practical solution. However, the OECD approach may be criticized for the substance of the fictional tax regime it creates — namely, the inconsistency between the character and the source standards, and the lack of a standard for the timing of the tax event.

There is inconsistency in the content of the standards adopted for character purposes and for source purposes. What is the period of work that the options are treated as compensating? Is it the period ending on the

[34]*Id.* at para. 12.7. In the case of options that are exercisable after a blocking period but do not require continued work with the employer, the work period will generally end on their grant. *Id.* at para. 12.8. Similarly, vesting of options is distinguished from situations in which options have already vested but may be forfeited if not exercised before the employment is terminated. *Id.* at para. 12.9. When the vesting period is not applied for an employee because of special circumstances such as termination of employment by the employer or retirement, the work period for that employee should end on the date from which services are no longer performed. *Id.* at para. 12.12.

[35]*Id.* at para. 12.10.

[36]*Id.* at para. 12.11.

[37]*See also* Bobbett and Avery Jones, *supra* note 24, at 6, summarizing a panel discussion in which it was noted that options compensating work performed during a period that predates their grant are unusual in the United States and in the United Kingdom. The panel further noted that in the United States, options are normally granted without pregrant employment requirements and that in the United Kingdom, such a period would be seen as a precondition to the grant and not as part of the contingent period of services.

[38]OECD commentary on article 15, para. 12.14.

[39]The apportionment rules of article 15 of the OECD model treaty are subject to those of article 16. As a result, article 16 of the OECD model treaty applies to payments made to a director in his capacity as such.

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exercise date, as suggested by the dividing line between the ordinary income articles (employment and directors' fee) and the capital gains article used for character purposes? Or is it the period ending on the vesting date, as is normally the case for sourcing purposes? It is difficult to provide a conceptual explanation for this difference. A practical explanation would be that the value of the options on their vesting date is often difficult to determine. Although this is irrelevant for sourcing purposes because the source is determined under a time-based allocation test, it is relevant for character purposes because the value of the options must be determined to divide the income between articles 15 or 16 of the OECD model treaty, as applicable, on the one hand, and article 13 of the OECD model treaty on the other hand. Also, as noted above, the OECD report views the exercise date as the character dividing line because it is the dividing line under the domestic laws of many states, it is pragmatic, and it is reasonable to treat an employee as an investor only from the time he invests his own capital and becomes a shareholder.[40]

I believe the last argument in the OECD report is incorrect and that an employee should be treated as an investor from the vesting date, even though he did not invest capital. This is because the vesting date is the date on which employment income is realized under general tax principles and because the employee bears the risk and reward profile of an investor regarding his options starting on their vesting date. He can sell the options on the vesting date and receive cash, or wait and benefit from any appreciation (or suffer from any depreciation) of the options' value. That the employee did not invest his own cash in the options does not mean he does not have capital at risk. The difficulty in the OECD approach can be illustrated in a situation in which traded options are granted to an employee without any vesting restrictions and the employee exercises them after five years. Under the OECD character rule, the five-year postgrant appreciation of the options will be treated as employment income even though the employee does not have to work during this period to be entitled to exercise the options.[41] It seems that the OECD's pragmatic approach, which takes into account the domestic laws of the majority of the states, does not rely on economic considerations.

As noted above, the treaty fictional tax regime addresses only two out of the three elements that normally shape the tax regime applicable to compensatory stock options. It sets standards for character and source but does not provide a standard for the timing of the tax event. Adopting such a standard would clarify the extent of the source taxing rights of the source state and the extent of the double tax relief that a residence state must grant. It would also provide a solution to the multiple residence situations, illustrated in Example 2 above, because the residency of an employee or director would be determined on an agreed date as opposed to the dates of the tax event under the domestic laws of each state. A timing standard may also be useful to address double taxation arising in situations of deemed realization events in one but not both states (for example, an exchange of options in a merger, a change in substantial terms of the options, or an exit tax) by providing that those events should be treated consistently (either recognized or disregarded).

Assuming a standard for the timing of the tax event is adopted, there is a question about what that standard should be. It can be the date on which the options are exercised, consistent with the character standard, or it can be the date on which options are vested, consistent with the source standard. Similarly, assuming that a conceptually consistent tax regime for taxation of compensatory stock options is adopted under which both the character and source standards reflect the agreed-on standard for the timing of the tax event, there is a question as to what that standard should be. The tension here is between a date that is conceptually correct under realization principles, which is the vesting date (see the discussion above), and a date that is more practical, which is the exercise date. The exercise date is more practical because it is often easier to determine the value of shares than the value of options and because this is consistent with the domestic laws of many states. As discussed above, however, in the cross-border context, relying on realization principles results in a more accurate allocation of taxing rights.

2. Determining Income Accrued During Work Period

Under the OECD commentary, if income is derived in multiple source states, the amount of income sourced in each state is based on a linear allocation rule that is a function of the number of days of work in each state divided by the number of days of work during the entire work period. An alternative to the time-based allocation approach would be a value-based allocation approach that looks at the appreciation in the options' value during the work period in each source state. A value-based approach might be viewed as more consistent with the facts

[40] *See supra* note 30.

[41] *See* Pötgens and Jakobsen Part I, *supra* note 24, at 413-414, supporting the vesting date as the characterization dividing line and citing the 2003 revised OECD report that states that ''since an employee does not have to provide employment services after the date of vesting, it would be difficult to argue that the option is remuneration for services between the vesting and exercise.'' The authors also mention the view that the OECD commentary might be deviating from its interpretive role in this case and therefore might be called into question.

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and circumstances test used to determine the work period, which, as noted above, is the other element determining the source of the income. I believe, however, that the time-based allocation approach is preferable for the reasons set forth below.[42]

First, a time-based allocation approach is simple to apply and provides taxpayers with certainty in the tax result because it does not require the determination of the options' value during the work period. Second, a test based on the actual appreciation in each state measures the value of the options before the date on which income is realized (before the date of the tax event). The value of the options during that period is irrelevant to the employee's income and therefore should not affect the tax consequence. The following example illustrates the difficulty in relying on a value that is determined at some point before the realization date: An employee worked sequentially in State A, State B, and State C. At the end of the work period in State A, State B, and State C, the value of the options was $80, $0, and $70, respectively. The options had no value on grant, and they vested at the end of the work period in State C. What is the amount of income that should be sourced in State A? It can't be $80 because the amount realized is only $70. Should it be zero because the value later depreciated? Or should it be (80/150)*70 to reflect the share of appreciation in the value of the options attributable to State A?

IV. The U.S. Approach

A. Summary of U.S. Approach

1. General

The U.S. model treaty and Treasury's technical explanation to that model[43] do not address the taxation of income from compensatory stock options, except for the technical explanation's statement that ''Article 14 also applies to income derived from the exercise of stock options granted with respect to services performed in the host State, even if those stock options are exercised after the employee has left the source country.''[44] In most treaties, therefore, there is no guidance on how to avoid double taxation or double non-taxation on income from compensatory stock options.

Taxation of income from compensatory stock options is explicitly addressed in three relatively recent U.S. treaties or formal documents under these treaties: the 2001 U.K.-U.S. treaty (the U.K. treaty), the 2003 Japan-U.S. treaty (the Japan treaty), and the 1980 Canada-U.S. treaty as amended by subsequent protocols, including the 2007 protocol (the Canadian treaty).[45] Although these treaties (collectively referred to as the U.S. treaties) are relatively new, they do not seem to reflect Treasury's intention to address the issues relating to compensatory stock options. This is because (1) other treaties that entered into force in recent years do not contain similar provisions; (2) the issues are not addressed in the recent versions of the U.S. model treaty or the technical explanation; and (3) the arrangements in these treaties are inconsistent with U.S. domestic laws described in more detail below.

The provisions addressing compensatory stock options in all three treaties are generally similar, although some differences exist. None of the U.S. treaties deal directly with the timing of the tax event, and all three source income from the options under a time-based allocation formula that looks at work days during the period between grant and exercise. The treaties differ in the character rule, that is, the dividing line that determines what income is subject to the employment income article and what income is subject to the capital gains article. None of the treaties address the treatment of stock options granted to members of a board of directors in their capacity as such. The particular arrangements under each treaty and the differences among the treaties are discussed below.

2. U.K. Treaty

The diplomatic notes exchanged between the United States and the United Kingdom relating to the U.K. treaty set forth three rules regarding the taxation of employee stock options.[46]

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[42]The 2002 OECD public discussion draft asked for comments on whether a value-based or other allocation method should be adopted. As noted, the final OECD report adhered to the time-based allocation test.

[43]The model treaty technical explanation is *available at* http://www.treas.gov/offices/tax-policy/library/TEMod006.pdf.

[44]Model Treaty Technical Explanation, article 14, para. 1.

[45]Article 29(7)(a) of the 1994 France-U.S. treaty addresses a limited aspect of the taxation of stock options. That article incorporates a provision that was included in a 1978 exchange of letters regarding the old France-U.S. treaty. The article applies solely to U.S. citizens who are French residents. It provides that for French tax purposes, the timing and amount of income from the exercise of stock options issued by U.S. companies will be determined based on the timing and amount of ordinary income recognition under U.S. tax principles. This provision does not apply to income characterized as capital gains.

[46]*See* Exchange of Notes accompanying the signature of the proposed U.K.-U.S. tax treaty (July 24, 2001) (U.K.-U.S. diplomatic notes), notes relating to article 14. The U.K.-U.S. diplomatic notes are *available at* http://www.treas.gov/offices/tax-policy/library/uknotes.pdf. Under the preamble to Treasury's technical explanation to the U.K. treaty, the notes constitute an agreement between the two governments that entered into force at the same time as the U.K. treaty entered into force. The technical explanation to the U.K. treaty is *available at* http://www.treas.gov/offices/tax-policy/library/teus-uk.pdf. For further discussion on the taxation of stock options under the U.K. treaty, see Sheldon I. Banoff and Richard M. Lipton, ''New U.S.-U.K. Tax Treaty Addresses the Taxation of Options,'' 97 *J. of Tax'n* 61 (2002).

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The first rule is that any income or gains of employees under option plans are subject to the employment income article (article 14 of the U.K. treaty).[47] Presumably, those gains include gains from the sale of shares acquired through the options if the gains are realized under the option plan.[48]

The second rule allocates source taxing jurisdiction between the United States and the United Kingdom if the following conditions are satisfied: (1) the employee has been granted the options in the course of an employment in the United States or the United Kingdom; (2) the employee worked in both states during the period between the options' grant and exercise; (3) the employee remains in employment on the date of exercise; and (4) the income from the options is taxable under the domestic laws of both states. Source taxing rights are allocated under a time-based allocation rule that is a function of the number of days that the employee worked in each state during the period between grant and exercise.[49] The technical explanation to the U.K. treaty clarifies this test by stating, ''The portion attributable to a Contracting State will be determined by multiplying the gain by a fraction, the numerator of which is the number of days during which the employee exercised his employment in that State and the denominator of which will be the total number of days between grant and exercise of the options.''[50]

The third rule is an agreement of the competent authorities to endeavor to resolve by mutual agreements any situation of unrelieved double taxation relating to income from stock options.

[47]The term ''option plans'' is undefined. It is not entirely clear why an option has to be granted under a plan for this rule to apply.

[48]The technical explanation to the U.K. treaty and the JCT's explanation to the U.K. treaty do not elaborate on this important issue. The JCT's explanation is *available at* http://frwebgate.access.gpo.gov/cgibin/getdoc.cgi?dbname=2003_joint_committee_on_taxation&docid=f:85199.pdf.

[49]More technically, the U.K.-U.S. diplomatic notes state that the nonresidence state, as determined on the exercise date, has a taxing right only regarding ''that proportion of the option gain which relates to the period or periods between the grant and the exercise of the option during which the individual has exercised the employment in that Contracting State.'' *See* the U.K.-U.S. diplomatic notes relating to article 14.

[50]*See* technical explanation to the U.K. treaty, article 14, para. 1. One difficulty with this formula is that the numerator takes into account only work days, while the denominator takes into account all days (work and nonwork days). Interestingly, under the Australia-U.K. treaty, the source taxing rights over income from employee stock options are generally allocated based on the work days during the vesting period. *See* Exchange of Notes accompanying the Australia-U.K. tax treaty (Aug. 21, 2003), sections 8(b) and (c).

3. Japan Treaty

The protocol to the Japan treaty provides three basic rules on employee stock options, which are generally similar to the rules under the U.K. treaty.[51]

Under the first rule, income from stock option plans ''relating to the period between grant and exercise'' is subject to the employment income article (article 14 of the Japan treaty).[52] Note that, contrary to the U.K. treaty's parallel rule, under the Japan treaty any income attributable to the period after the exercise date of the options is subject not to article 14, but rather to article 13 of the Japan treaty relating to capital gains.[53] This rule is similar to the OECD character rule discussed above.

Under the second rule, source taxing rights are allocated between the United States and Japan under a time-based formula if specific conditions are satisfied. These conditions are similar to those in the U.K. treaty, and the allocation formula is identical to that of the U.K. treaty. However, as noted above, the income subject to this allocation formula may be different from that under the U.K. treaty.

Finally, as in the U.K. treaty, the third rule provides that the competent authorities will endeavor to resolve by mutual agreement any situation of unrelieved double taxation relating to income from compensatory stock options. The United States and Japan signed a joint statement titled ''Understanding of the Negotiators'' (Understanding of the Japan-U.S. Negotiators) to ''establish a framework by which double taxation can be avoided to the maximum extent possible.'' That document states that mutual agreements will provide that the residence state will grant FTCs for any taxes paid to the source state in accordance with the treaty,

[51]Protocol Regarding the Convention Between the United States and Japan, signed Nov. 6, 2003 (the Japan Protocol), para. 10. The Japan Protocol is *available at* http://www.treas.gov/offices/tax-policy/library/japanprotocol.pdf. Those rules are further explained in the Understanding of the Japan-U.S. Negotiators (as defined in the text above) and accompanying Annex dated Nov. 6, 2003, which are attached to the Treasury's technical explanation to the Japan treaty, *available at* http://www.treas.gov/press/releases/reports/tejapan04.pdf.

[52]As in the U.K. treaty, ''option plans'' is not a defined term. *See supra* note 47.

[53]*Cf.* the language under the U.K.-U.S. diplomatic notes stating that article 14 of the U.K treaty controls ''any benefits, income or gains enjoyed by employees under share/stock options plans'' with the language under the Japan Protocol according to which article 14 controls ''the benefits enjoyed by employees under stock option plans relating to the period between grant and exercise of an option.'' The technical explanation to the Japan treaty and the JCT's explanation to the Japan treaty do not elaborate on this important point. The JCT's explanation to the Japan treaty is *available at* http://www.house.gov/jct/s-1-04.pdf.

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without regard to limitations imposed under domestic laws, such as limitations on carryover of FTCs.[54]

4. Canadian Treaty

The diplomatic notes exchanged between the United States and Canada in connection with the fifth protocol to the Canadian treaty address some issues relating to stock options granted to individuals in their capacity as employees of corporations or mutual funds.[55]

The diplomatic notes provide a time-based allocation rule for the apportionment of source taxing jurisdiction between the United States and Canada. The allocation rule applies to income from the exercise or disposition (including a deemed exercise or disposition) of options, and income from sale (including a deemed sale) of the shares or units acquired through exercise of the options.[56] Under this rule, each country has source taxing jurisdiction over a percentage of the income equal to a fraction the numerator of which is the number of days from grant to exercise (or disposition of the options) in which the principal place of employment was situated in that country, and the denominator of which is the number of days from grant to exercise (or disposition of the options) during which the employee was employed by the employer (or a related entity).[57]

The diplomatic notes provide for an exception to this time-based allocation rule when the competent authorities agree that the grant of the options is economically equivalent to a transfer of an ownership interest in the underlying shares or units (for example, because the options were in the money or with no vesting period). In those cases, the competent authorities may agree ''to attribute income accordingly.'' Presumably, the intention is that the country with the source taxing jurisdiction will be the country where the employee worked on or before the date the options were granted.[58]

B. Comments on U.S. Approach

The scope of the rules applicable to compensatory stock options under the U.S. treaties is limited because they address only the character of the income (by stating which income is subject to the employment income article) and its source (by providing an allocation rule for source taxing rights).

1. Timing Rule

Similar to the approach taken in the OECD commentary, the U.S. treaties do not provide a timing standard for the recognition of income from compensatory stock options.

Situations of multiple residence-based taxation (as illustrated in Example 2) are prevented under the U.K. and Japan treaties because under their source allocation rule, the nonresidence state (as determined on the exercise date) can tax only income sourced in that state and it therefore cannot tax income sourced in a third state. The Canadian treaty does not have a similar rule.

Situations of FTCs that are limited under domestic tax rules (as illustrated in Example 1) are generally left

[54]*See* Understanding of the Japan-U.S. Treaty Negotiators. This statement is also made in the Annex to the Understanding of the Japan-U.S. Treaty Negotiators. The Annex provides 16 fact patterns of compensatory stock options granted to employees, with the variants being the residency of the employee on the exercise date, the residency of the employee on the date of the sale of the shares received from the options, and the nature of the options as qualified (options that satisfy specific conditions and the income from which is taxed only on the sale of the underlying shares) or nonqualified under the domestic laws of each state. It is noted that while no double tax issues arise if both states' domestic tax laws treat the options consistently (as qualified or nonqualified), in some cases of inconsistent treatment double tax may arise and may not be alleviated under the rules in the protocol. The Understanding of the Japan-U.S. Treaty Negotiators notes that in these cases, the competent authorities will enter into mutual agreements to alleviate the double tax.

[55]Exchange of Notes accompanying the Canada-U.S. fifth protocol, signed Sept. 21, 2007, para. 6. The diplomatic notes are *available at* http://www.treas.gov/offices/tax-policy/library/CanadaDipNotes07.pdf. The diplomatic notes are clarified and supplemented by the technical explanation to the Canadian treaty, *available at* http://www.treas.gov/press/releases/reports/tecanada08.pdf. The introduction to the technical explanation to the Canadian treaty notes that the government of Canada has reviewed this document and subscribes to its contents and that therefore the document reflects ''understandings reached with respect to the application and interpretation of the Protocol and the Convention.''

[56]Under the technical explanation to the Canadian treaty, the reference to disposition of shares and units was made because under Canadian law and some provisions of U.S. law, income from stock options may in some cases not be recognized until the shares and options are sold. *See* Technical Explanation to the Canadian Treaty, article 10.

[57]Under the technical explanation to the Canadian treaty the following two conditions must be satisfied for the allocation rule to apply: the employee received the options in the course of employment in the United States or Canada, and his principal place of employment has been in one or both of these states during the period between grant and exercise (or disposal) of the options. *See* Technical Explanation to the Canadian treaty, article 10.

[58]One other innovation of the Canadian treaty concerns the application of article 15(2), which deals with the exclusion of the source state's right of taxation. The technical explanation to the Canadian treaty clarifies that the tests of article 15(2) of the Canadian treaty are applied for the year or years in which the relevant services were performed and not for the year in which the options were exercised or sold. *See* Canadian Technical Explanation, article 10. *See also* the JCT explanation to the Canadian treaty, at 59, *available at* http://www.jct.gov/x-57-08.pdf.

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to be resolved in mutual agreements between the competent authorities. The Understanding of the Japan-U.S. Treaty Negotiators specifically states that the mutual agreements will provide double tax relief without regard to FTC limitations under domestic laws. It would be helpful to have an express rule in treaties providing that FTC limitations under domestic laws are inapplicable in the context of compensatory stock options, instead of leaving this matter to the mutual agreement procedure.

2. Character Rule

Under the Japan treaty, income relating to the period between grant and exercise is subject to the employment income article, while under the U.K. and Canadian treaties, in some circumstances income from the disposition of stock acquired through the options is also subject to the employment income article. Under the approach adopted in the OECD commentary, the dividing line between employment income and capital gains is the exercise date of the options. As noted above, the conceptual right date under realization principles is the vesting date. Therefore, pushing the character dividing line to a postvesting date is inconsistent with these principles. Pushing the character dividing line even further to a postexercise date seems to be inappropriate given the relative ease of valuing options on their exercise date as opposed to their vesting date. Thus, the practical valuation consideration (supporting deferral of the character dividing line from the vesting date to the exercise date) is diminished.

3. Source Rule

Before turning to the U.S. treaties' source rules, it would be useful to summarize the employment income's source rule under U.S. domestic laws. Under Treasury regulations finalized in 2005, the source of income from labor or personal services (other than compensation in the form of some fringe benefits) performed by an individual employee partly within and partly outside the United States is generally determined under a time-based test.[59] Under that test, the amount of employment income sourced in the United States is equal to the employment income multiplied by a fraction the numerator of which is the number of work days within the United States during the period to which the compensation relates and the denominator of which is the total number of work days during that period.[60] However, the time-based test may be substituted with an alternative test by the employee if he establishes to the IRS's satisfaction that the alternative test more properly determines the source and if other conditions are met, or by the IRS under certain circumstances.[61] This approach, having a time-based source rule that can be substituted only if an alternative test more properly reflects the source, is a compromise between two competing approaches that were alternately used over the years in prior versions of the regulations.[62]

This approach also applies to determine the source of income from multi-year compensation arrangements, defined as compensation included in the income of an individual in one tax year but that relates to two or

[59]Reg. section 1.861-4(b)(2)(ii)(A). The source of labor or personal services performed partly within and partly outside the United States by persons other than individuals or by individuals who are not employees is determined on the basis that most correctly reflects the source under the facts and circumstances of the particular case. The preamble to the 2004 proposed regulations provides that for this group of persons, the facts and circumstances test may be more appropriate in many cases. For example, payroll costs or another basis besides time may more correctly reflect the source if a corporation receives payments under a contract for services to be performed by numerous employees at various pay levels in several different geographic locations. *See* preamble to prop. reg. section 1.861-4 (Aug. 6, 2004). For a comprehensive analysis of the U.S. federal income tax aspects applicable to nonresidents exercising employee stock options, see Dana Goldblatt and Stanford Smiley, ''Exercises of Employee Stock Options by Non-Resident Aliens,'' 34 *J. of Corp. Tax'n* 30 (2007).

(Footnote continued in next column.)

[60]Reg. section 1.861-4(b)(2)(ii)(E). In some circumstances, a unit of time of less than a day may be appropriate. The period to which compensation relates that is used as the basis for the denominator is presumed to be a calendar year unless (1) the taxpayer establishes that another distinct, separate, and continuous period is more appropriate (for example, a permanent relocation during the calendar year without short-term returns to the United States to perform services may establish two periods within a calendar year) or (2) the arrangement is a multi-year compensation arrangement, in which case several years will be used as the period to which compensation relates, as discussed in more detail in the main text.

[61]Reg. section 1.861-4(b)(2)(ii)(C)(1). Also, proposed regulations issued in 2007 source income attributable to the performance of labor or services at a specific event (*e.g.*, by artists, athletes, or presenters) based on the geographic location of the event. *See* prop. reg. section 1.861-4(b)(ii)(G).

[62]The two competing approaches are a rigid time-based allocation approach and a facts and circumstances approach that allocates source on the basis that most properly determines the source. For tax years beginning before 1976, source was apportioned based on a rigid time-based allocation formula. *See* T.D. 6258 (Oct. 23, 1957). For tax years beginning on or after 1976 (and before July 14, 2005) source was apportioned under the facts and circumstances approach. *See* T.D. 7378 (Sept. 29, 1975). LTR 9037008 (May 29, 1990) applied these regulations to employees' income from stock options, and provided for time-based allocation unless some other basis more correctly reflects the source under the facts and circumstances test. Proposed regulations published in 2000 reverted to the rigid time-based allocation approach for individuals. *See* preamble to prop. reg. section 1.861-4 (Jan. 20, 2000). For a criticism on this approach, see Allison E. Weilobob, ''U.S. and International Taxation of Compensatory Stock Options — An Overview of Some Current Issues,'' 32 *Tax Mgmt. Compensation Planning J.* 75 (2004). These proposed regulations were withdrawn when the proposed regulations using the current approach were published in 2004. *See* preamble to prop. reg. section 1.861-4 (Aug. 6, 2004).

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more tax years.[63] For purposes of the time-based test, the period of work for which compensation is made under those arrangements is determined based on the facts and circumstances of each case. Importantly, the regulations state that in the context of employee stock options, that period is generally the period between grant and vesting.[64]

The U.S. treaties do not directly set a standard for the work period, but because the apportionment rule of all three treaties generally relies on the period between grant and exercise, they effectively set this time as the work period. This is different from the approach adopted in Treasury regulations and in the OECD commentary, which use a more flexible approach that can take into account the facts and circumstances of each case.[65] Also, while the work period under the U.S. treaties always ends on the exercise date, the work period under the Treasury regulations and the OECD commentary generally ends on the vesting date. It is unclear why the period between grant and exercise was adopted as the basis for the apportionment rule mentioned above since this period has nothing to do with the time during which the employee acquires his rights to exercise his options. Also, relying on the exercise date (not a fixed date) rather than the vesting date (a fixed date that is known as of the grant date) may complicate compliance and provide employees with the ability to affect the source of income by choosing the exercise date. Finally, the approach regarding the work period in U.S. treaties can lead to erroneous results.[66] For example, when options are granted to an employee without any vesting restrictions and right after the grant the employee relocates out of the United States to the other contracting state, the employee's entire income will be sourced in the other contracting state even though the employee acquired the right to exercise the options based on his work in the United States. This is because the employee worked in the other contracting state during the period from grant to exercise.

The Canadian treaty includes an exception to the general source rule under which source will be determined not under the time-based allocation formula, but rather will be agreed on by the competent authorities. This exception applies when ownership in the underlying shares or units is transferred on grant of the options. For U.S. tax purposes, a call option may be treated as conveying tax ownership in the underlying shares before its exercise if the option is granted with deep discount.[67] Because of regulatory constraints, this situation is rare in practice.[68] I believe a better approach would be for this exception to apply whenever options are transferred without substantial vesting restrictions, even if ownership in the underlying securities is not transferred. In those cases, because the right to exercise the options has already been acquired by the employee on the grant date, it does not make much sense to look to the period between grant and exercise for purposes of determining the source. Instead, the source should be determined as of the date of grant or based on a period ending on the grant date.

The time-based allocation concept used to apportion source taxing rights under the U.S. treaties is similar to the time-based allocation approach adopted in the OECD commentary and, as discussed above in Part III.B.2, is preferable over a value-based approach (assuming it uses the correct work period as the basis for its formulary allocations).[69] As noted, contrary to the approach of the Treasury regulations, the U.S. treaties' source rule does not offer an alternative test for situations in which the time-based test does not properly reflect the source. This approach is understandable in

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[63]The preamble to the 2005 final regulations confirms the application of the alternative test for purposes of sourcing income from multi-year compensation arrangements when the time-based test does not properly determine the source. *See* T.D. 9212 (July 13, 2005).

[64]Reg. section 1.861-4(b)(2)(ii)(F). *See also* reg. section 1.861-4(b)(2)(ii)(G), Example 6 (70 percent of an employee's income recognized on the exercise of compensatory stock options is sourced in the United States because the employee worked 70 percent of the time during the vesting period in the United States; also clarifying that employment after the vesting day is irrelevant to the source determination). This was also the IRS's position before the promulgation of these regulations. *See* LTR 9037008 (May 29, 1990) (services giving rise to income from stock option plans are generally the services performed during the vesting period). *See also* LTR 871107 (Dec. 18, 1986) (source of income from employee restricted stock compensation plan is determined based on the vesting period).

[65]For a discussion on the OECD approach, see Part III.A.4.

[66]Also, the different approaches in the U.S. domestic laws and the U.S. treaties regarding source determinations may lead to an administrative burden resulting from the need to keep track of data under both approaches.

[67]*See, e.g.*, Rev. Rul. 82-150, 1982-2 C.B. 110 (holder of option to purchase stock of a corporation at a price equal to 30 percent of its value when option is granted treated as owner of the stock).

[68]Issuance of options even with a slight discount (that is, options of which the exercise price is below the FMV at the time of grant) results in the option being subject to section 409A. *See* reg. section 1.409A-1(b)(5).

[69]Note that there is a difference in the time-based allocation test between the U.K. and Japan treaties on one hand and the Canadian treaty on the other hand. The difference is in the numerator of the allocation formula. Both the U.K. and Japan treaties count work days in a particular state while the Canadian treaty counts days during which the principal place of employment was situated in a particular state. The denominator in all three treaties is the number of days between grant and exercise. The OECD uses as the numerator the work days in a particular state during the work period and as denominator the total number of work days during the work period (which is generally the period between grant and vesting).

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light of the desire to formulate a simple rule that provides clear results to avoid manipulations by taxpayers and disputes between the contracting states.

One other feature of the source rule under the U.S. treaties is that for the apportionment rule to apply, some conditions must be satisfied. However, it is hard to find a reason to justify these conditions. Why, for example, is it relevant that the employee has been granted the options in the course of an employment in the United States or the other contracting state as opposed to a third country? Why is it relevant that the employee remain in employment on the date of exercise?

4. Conceptual Inconsistency

There is a conceptual inconsistency between the U.S. treaties' rules relating to character and those relating to source. The source rules under the U.S. treaties generally assume that the options compensate work exercised between the grant and exercise dates, while the character rules under the U.K. and Canadian treaties (but not the Japan treaty) in some circumstances treat income that relates to a postexercise period as income from employment. The level of inconsistency in the U.S. treaties, however, is insignificant compared with that in the OECD commentary, under which source is generally determined based on the period ending on the vesting date while character is generally determined based on the period ending on the exercise date.[70]

V. Conclusions

Tax treaties may not provide adequate protection against double taxation and double nontaxation of income from compensatory stock options. Therefore, to remove tax impediments on the free mobility of human capital, additional agreements should be reached between the contracting states. Elimination of double taxation and double nontaxation can be achieved by neutralizing one or both elements that cause them to arise. These are the treaty apportionment rules granting both contracting states taxing rights over the income and the inconsistency in the timing, character, and source of the income under the domestic laws of the contracting states.

It is possible to neutralize the first element (treaty taxing rights to both contracting states) by adopting an apportionment rule that grants an exclusive right of taxation to only one of the two contracting states based on an agreed criterion such as residence or source. A residence-based criterion is the most appropriate for U.S. treaties because it is consistent with the progressive nature of the U.S. individual income tax system as well as with the principle of capital export neutrality on which the code's double tax relief provisions are based. The main difficulty with a residence-based exclusive right, however, is that it deprives the source state from its natural primary right of taxation over the income in deviation from the well-established place of performance principle. Also, any exclusive right of taxation results in different apportionment rules and different effective tax rates applicable to compensation for services that is paid in options compared with other forms of compensation.

It is possible to neutralize the second element (domestic laws' inconsistencies between the contracting states) by adopting consistent standards relating to the timing, character, and source of income from options solely for purposes of applying the treaty provisions. In effect, these standards create a fictional tax regime for purposes of the treaty. This approach was adopted in the OECD commentary in 2005 as well as in three U.S. treaties. Both the OECD commentary and the U.S. treaties may be criticized for providing agreed-on character and source standards but being silent on the timing standard. Conceptually, the timing standard should dictate the character (services income until the tax event date and capital gains thereafter) and source (period of work compensated by the options ends on the tax event date) standards; therefore, all three standards should be aligned. The OECD commentary may also be criticized for the inconsistency between the character and source standards it provides. Under its character standard, the options are generally treated as compensating work performed between grant and exercise, while under its source standard the work period is generally the period between grant and vesting. The U.S. treaties also have a level of inconsistency, but to a lesser degree.

I believe all three standards should be based on the vesting date rather than the exercise date. The exercise date might be more practical because the valuation of the options on this date is generally simpler and is consistent with the domestic laws of many states. However, taxing rights should be apportioned between the two contracting states based on the economic substance of the income's amount, character, and source, all of which stem from the income's realization date. The vesting date is the date on which income from the options is realized under general economic principles and therefore is the appropriate date to be adopted for these purposes.

Treasury did not address the tax treaty issues relating to compensatory stock options in the 2006 U.S. model treaty or its accompanying technical explanation. Other than the treaties with the United Kingdom, Japan, and Canada, no U.S. treaty, including the most recent treaties and protocols, deals with compensatory stock options. Further, the stock option provisions in the three treaties do not seem to reflect a comprehensive Treasury policy, as they are limited and inconsistent with Treasury regulations, particularly regarding the source of the income. It seems that Treasury's work in this area is necessary and most welcome. ◆

[70]For a discussion on the OECD commentary's conceptual inconsistencies, see Part IV.B.4.

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