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A PUBLIC DISCUSSION DRAFT

A Cross-Border Income Tax Issues Arising from Employee Stock-Option Plans

Deadline for comments: 31 July 2002

CROSS-BORDER INCOME TAX ISSUES ARISING FROM EMPLOYEE STOCK-OPTION PLANS

A PUBLIC DISCUSSION DRAFT

Working Party No. 1 on Tax Conventions and Related Questions is the sub-group of the OECD Committee on Fiscal Affairs that deals with tax treaty issues.

The Working Party has undertaken work on a number of cross-border issues related to employee stock-options. As part of that work, the attached note has been produced by a working group. The note describes some of the treaty issues that may arise in the case of employee stock-options, examines the application of the relevant provisions of treaties based on the OECD Model Tax Convention and proposes possible interpretation and solutions where appropriate.

The Working Party believes that the note provides a useful starting point for clarifying the application of tax treaties with respect to employee stock-options. It also believes that before further work is carried out on the basis of this note, it could benefit from the early views of all persons interested in this issue. It therefore invites interested parties to send their comments on this note before 31 July 2002.

In releasing this note for comments, the Working Party wishes to stress the preliminary nature of its contents. The note reflects the work of a small number of delegates and it is agreed that further discussion is necessary. While the delegates who drafted the note agreed that the note should be released for comments, they also indicated that they did not necessarily support all the conclusions included therein. For these reasons, the note should not be considered to reflect the views of the OECD or of any of its Member countries.

The Working Party also wishes to emphasise that its work does not relate to all tax issues related to employee stock-options. Paragraphs 1 to 3 of the note describe the scope of the Working Party's work. It should be noted, in particular, that this work does not include transfer pricing issues, which are currently being examined by Working Party No. 6, the subsidiary body of the Committee on Fiscal Affairs that deals with such issues.

The Working Party invites comments from interested parties on both the issues described in this note, any other tax treaty issue that may arise from employee stock-options and the various possible solutions and interpretations put forward in the note.

Comments on the note should be sent before 31 July 2002 to:

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CROSS-BORDER INCOME TAX ISSUES ARISING FROM EMPLOYEE STOCK-OPTION PLANS

Introduction

1. This note considers the cross-border tax treaty issues that may arise from the use of stock-options as part of employee remuneration packages and provides a preliminary discussion of possible ways to address some of these issues. While the note focuses primarily on issues related to the taxation of the employee, it should be noted that employee stock-option plans (ESOPs)[1] also raise transfer pricing issues which are currently being examined by Working Party No. 6, the subsidiary body of the Committee on Fiscal Affairs that deals with such issues.

2. This note deals exclusively with ESOPs and not with other forms of equity-based remuneration such as share grant or share purchase plans, [2] phantom stock plans, share appreciation rights or employee options granted by non-corporate employers (e.g. mutual fund trusts granting options to acquire units of the trust). While many of the issues and principles discussed in this note would be relevant as regards the tax treatment of such forms of equity-based remuneration, the characteristics of each of these would need to be taken into account before reaching any conclusion as to how or whether to apply to them the principles developed in this note. For purposes of this note, however, no distinction should be made between "in the money"[3] and "out of money" options so that options are covered by this note regardless of whether they provide for a strike price that is less than, equal to, or greater than the value of the underlying share at the time of grant.

3. This note does not deal with

- issues concerning Article 16 that may arise from the granting of stock-options to members of a board of directors and

- social security issues relative to stock-options.

Also, valuation issues related to equity-based remuneration are only dealt with to a limited extent, i.e. primarily as regards situations where shares are quoted in different currencies on different stock-exchanges or where there are related currency-exchange issues.

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1 . In the United States, the acronym "ESOP" refers to employee stock-ownership plans. For the purposes of this document, however, the acronym refers exclusively to employee stock-option plans.

2 . For the purpose of this note, plans that are called "share purchase plans" but which grant employees options or other rights to purchase employer's shares (such as so-called "section 423 plans" in the United States) are considered ESOPs as opposed to plans that simply permit the direct receipt or purchase of employer's shares by the employee.

3 . An "in the money option" refers to an option to acquire a share at a price that is below the market value of that share. Conversely, an "out of money option" refers to an option to acquire a share at a price that is equal to or above the market value of that share.

Background on ESOPs

4. The following briefly describes some of the various aspects of ESOPs as understood for purposes of this note:

Stock-option — A stock-option is a call option, i.e. a right to acquire a share from a given seller at a given moment (so-called European options) or during a given period (so-called American options) for a given price (strike price).

ESOP — Under an ESOP, stock-options are granted to employees usually subject to certain restrictions (e.g. vesting period). The “seller” of the shares is often, but not necessarily, the employer (e.g. the “seller” could be an associated enterprise). The share that is acquired pursuant to a stock-option plan is typically issued by the company at that time but it is not uncommon for the share to be a previously issued share that was acquired by the company on the market. Under a typical ESOP, the time of grant corresponds to the moment when the employee is given, generally subject to certain conditions such as a vesting period, options to acquire shares during a certain period of time. When the conditions under which the options may be forfeited have all disappeared, the option is said to have “irrevocably vested”.[4]

Benefit to the employee[5] — Benefit when the option is granted (or when it subsequently vests): The option is granted to the employee free of charge or below its market value at the time it is granted. When the option vests, the employee has an irrevocable right which he can sell or use for the acquisition of a share below the market price of the share at the time it is acquired.

Benefit when the option is exercised: The employee acquires a share at a price below market value and the benefit corresponds to the difference between the price paid and the market value of the share at that time.[6]

Benefit when the shares are sold: To the extent that shares that have been acquired with a stock-option subsequently increase in value, that increase can be realised by simply selling the shares at market value.

Value of a stock option — Financially, an option can be valued at any time, including the time when it is granted (if the period for exercising the option is too long or the conditions attached to it too complex, however, the evaluation risks becoming too approximate to be reliable). Financial economists have designed formulae (e.g. the Black-Schöles formula) to determine the

4 . For tax purposes, however, some countries may consider that there is no irrevocable vesting as long as the shares acquired after the exercise of the option may be forfeited under some conditions.

5 . The annex presents a graphic illustration of the various events in relation to an employee stock-option and the benefit accruing at those events.

6 . Another benefit that derives from the exercise of the option is the dividends that the employee can subsequently receive as a shareholder.

value of the option. That formula is based on the following parameters (which may themselves need to be estimated): spot price of the share, strike price, maturity, volatility, interest rate and dividend payments. The value of an option also depends on the restrictions placed on the option (e.g. a vesting period for the exercise or transfer or a right of cancellation).

Issues related to the employee

Timing mismatch in taxing the employment benefit

Description

5. The fact that the benefits from an employee stock-option are taxed at different times in different countries is a clear source of difficulties.

6. Typically, a country may tax the benefits resulting from an employee stock-option plan at one or more of the following events:[7]

- when the option is granted;
- when the option irrevocably vests[8];
- when the option is exercised or otherwise disposed of;
- when there are no longer any restrictions on the sale of the shares acquired under the option; or
- when the shares acquired under the option are sold[9].

7. Also, the same country may tax different parts of the benefits at different times. One example would be where one part of the benefit is taxed at the time the option is granted and another part at the time the shares are sold; another example would be where the "in the money" portion of the benefit related to a

7 . This list is not exhaustive since, in some countries, taxation may also occur at other events (e.g. when an employee ceases to be a resident).

8. Among the typical conditions that must be met before an employee can exercise the option that has been granted to him, it is usually required that the employee continues to work for the employer during a certain period of time. The option is not considered to have irrevocably vested before these conditions, including the period of employment, are met. In many countries, however, a condition subsequent or a resolutory condition would not prevent the option from vesting (e.g. a condition that is applicable after the option becomes exercisable and under which the option will be lost if employment is terminated before the option is exercised). In some countries, the option arguably never vests irrevocably until it is exercised (e.g. that would be the case in the above example since the option may be lost upon termination of employment).

9. It should be noted that in a number of countries, the tax treatment of the benefits from a stock-option or the gain resulting from the sale of the shares may differ depending on how long the shares have been owned after their acquisition by the employee.

stock-option is taxed earlier than the residual benefit (i.e. the benefit that represents the increase in the value of the share after the option was granted).

8. Clearly, where different countries tax the benefits of ESOPs at different times, this may result in the usual problem of relieving double taxation when the States of residence and source do not tax at the same time (problems which are partly addressed by carry-forward or carry-back of foreign tax credits).

9. This may also result, however, in questions as to whether relief should be given at all and if yes, on what income. For instance, if the State of residence does not tax stock-options but considers instead that the whole amount of a gain realised upon the sale of the shares is a capital gain, it may be reluctant to exempt the income taxed in the State of source on a different event (e.g. the exercise of the option) or to grant a credit for that tax. Even if the State of residence agrees to give a credit, it will usually restrict the credit to the amount of domestic tax levied on the same income, which would require it to identify the portion of what it views as a capital gain that corresponds to what has been taxed by the State of source.

> *Example:* Employee E, who is currently a resident of State A, worked seven months in State B. Part of the remuneration that E derived from his employment in State B was stock-options of company Y, a resident of State B. Under State B law, the employment benefit resulting from stock-options is taxed when the shares are sold and is deemed to correspond to the difference between the sale price of the shares and the strike price (the amount paid by the employee). In State A, the employment benefit resulting from stock-options corresponds to the difference between the value of the shares when the option is exercised and the amount paid by the employee; that benefit is taxed when the option is exercised. E exercises the option in year 1, when he is taxed in State A. He sells the shares in year 3, when State B taxes him on the gain.

10. Article 15 allows the State of source to tax not only income from employment which is paid, credited or otherwise definitively acquired when the employee is present therein but also any income obtained or realised before or after such presence that is derived from the services performed in the State of source. The condition in Article 15 for taxation by the State of source is that the income concerned is derived from the exercise of employment in that State, regardless of when that income may be paid, credited etc. State B can therefore tax the gain in accordance with Article 15. However, State B will levy that tax upon the sale of the shares. Since State A will have already taxed the same benefit two years earlier, how will relief from double taxation be granted? Also, will State A be able to argue that State B has taxed a different event so as to deny relief? Finally, should State A attempt to determine which part of the tax levied by State B corresponds to what it taxes (i.e. the difference between the strike price and the value of the share at the time that the option was exercised)?

11. An additional problem may arise if the domestic law of State A sources the benefit from the exercise of the stock-option to State A and not to State B. In that case, however, if State A recognises State B's right to tax the benefit under the State A-State B tax convention, the treaty rules concerning elimination of double taxation (if they are based on the OECD Model) would effectively require State A to exempt or to give a credit (as explained in Part III of the report on the Application of the OECD Model Tax Convention to Partnerships).

12. The different country rules for taxing stock-options therefore create risks of double taxation. While it may be argued that the same risk arises with respect to any part of an employee's remuneration, including his salary, the fact is that it is more likely to be a problem in the case of stock-options. This is because stock-options are often taxed at a time (e.g. when the option is exercised or the shares sold) that is very different from the time when the employment services are rendered.

Possible ways of addressing the issue

13. Timing mismatches in taxing stock-options may result in the usual problem of relieving double taxation when the States of residence and source do not tax at the same time (problems which are partly addressed by carry-forward or carry-back of foreign tax credits). This issue could partly be addressed by indicating, in the Commentary, that the application of the relief of double taxation provisions of the OECD Model Convention are not restricted in time, i.e. that relief must be given even if the State of residence taxes at a different time than the State of source. This change may not, however, solve the issue as regards the countries that do not follow Article 23A or 23B of the Model Tax Convention, for instance because they link the relief of double taxation that they give under tax conventions to what is provided under their domestic laws; these countries, however, would be expected to seek other ways to relieve the double taxation which might otherwise arise.

14. In light of this conclusion, it would also be useful to expressly confirm in the Commentary that Article 15 does not restrict the State of source's right to tax income from employment to income that is paid, credited or otherwise definitely acquired when the employee is present in the State of source. Under Article 15, the State of source has the right to tax the part of the stock-option benefit that constitutes employment income derived from services exercised in the State of source even if the State of source taxes it at a later time when the employee is no longer rendering services in that State. The State of residence must therefore provide relief of double taxation with respect to such income even though the State of source taxes it at such later time.

15. The other issue discussed in paragraph 10 above arises where the State of residence and the State of source not only tax at different times but, in so doing, also characterise the benefit differently (capital gain or employment income). A solution to that problem is discussed below.

16. As regards the sourcing problem discussed in paragraph 11 of the note, the solution is already noted in that paragraph. The State of residence must recognise the State of source's right to tax the benefit under the sourcing rules of the convention entered into by these two States and the rules of the convention concerning elimination of double taxation (if they are based on the OECD Model) effectively require the State of residence to exempt or to give a credit even if its domestic law sources the income differently (as explained in Part III of the report on the Application of the OECD Model Tax Convention to Partnerships).

Distinguishing employment income from capital gains

17. There is no doubt that a stock-option provided as part of an employment package falls within the words "salaries, wages and other similar remuneration", even when it is granted by a company which is not the employer of the recipient (e.g. when the ESOP covers employees of subsidiaries).[10] While it is clear that the granting of an employee stock-option constitutes part of the remuneration of the employee for purposes of Article 15, it could be argued that the holding and subsequent exercise of the option constitutes purely an investment decision. Under that approach, the difference between the gain realised at the time of exercising the option and the value of the option at the time it was granted could be seen as falling under Article 13, which would not allow source taxation of the gain, rather than Article 15, which would.

10. It is recognised, however, that, in some countries, the imposition of withholding tax obligations on the direct employer may create administrative difficulties when the option is granted by a third party and is not considered to be provided by the employer.

Example: Employee E, a resident of State A, worked two years in State B. Part of the remuneration that E derived from his employment in State B were stock-options of company Y, a resident of State B. Options to acquire shares of company Y which are identical to the stock-options granted to E are regularly traded on State B's stock exchange. The value of the option given to E could therefore easily be determined at the time of granting. Assuming that the option has irrevocably vested at the time of granting, one could argue that between that time and the time at which the option is exercised, the situation of E is the same as that of any investor who would have acquired the option through the stock exchange, i.e. they both will monitor the market price of the underlying share to determine if and when to exercise the option. For that reason, it could be argued that any gain realised during that time should be treated the same way.

18. The approach described above would suggest that Article 15 can only apply to the value of the option when granted. It could therefore result in conflicts of interpretation given the large number of countries which tax as employment income the whole gain realised at the time of exercising the option (i.e. the difference between the market value of the share at that time and the amount paid by the employee to acquire it). Such conflicts would result in possible double taxation or non-taxation risks.

19. Apart from this possible conflict of interpretation, a conflict of qualification could arise between a country taxing a stock-option at the time of granting and one taxing it at the time of exercising. The first State would probably conclude that, under its domestic law, the amount of the capital gain realised upon the sale of the shares which falls under Article 13 (and is therefore not taxable in the State of source) is the difference between the sale price and the total of the strike price and the value of the option when it was granted. The latter State, however, would consider that the capital gain would only be the part of the gain that exceeds the value of the share at the time of exercising the option. To the extent that the first State would agree that the latter State's view does not violate the treaty, this would be a conflict of qualification within the meaning of Section III of the report on the Application of the Model Tax Convention to Partnerships and should be dealt with and solved according to the principles described in paragraphs 32.1 to 32.7 of the Commentary on Articles 23A and 23B. Thus, since the first State agrees that that the latter State's taxation does not violate the treaty, that taxation must be considered to be "in accordance with the provisions of the Convention" and the first State must provide relief (to the extent that the Article on elimination of double taxation of the relevant Convention is based on the wording of the Model Tax Convention).

20. The issue of whether a gain is a capital gain or employment income also arises with respect to gains realised upon the alienation of stock-options by an employee. Such alienation could occur if the options are sold or upon their cancellation or acquisition by the employer (e.g. on termination of employment).

21. Treaty mismatches resulting in double taxation or non-taxation are especially likely to occur where a country treats the entire benefit from an employee stock-option as a capital gain since a majority of countries would consider the totality or at least part of that benefit as employment income.

Possible ways of addressing this issue

22. This issue could be solved by clarifying, in the Commentary, from which time the benefits resulting from the option fall under Article 13 and are no longer covered by Article 15. At the same time, it could be clarified that the benefits resulting from the option would not generally fall under either Article 21 or Article 18.

23. Assuming that it is agreed that Article 15 cannot apply to the whole of the gain from the granting of the option to the sale of the shares, the most logical dividing line would seem to be the date when the option is exercised. Indeed, it is at that time that the option, which is what the employee obtained from his employment, disappears and the recipient obtains the status of shareholder.

24. On that basis, the Commentary could be clarified to indicate that Article 15 applies to the benefit realised directly from the option and which ultimately represents the difference between the value and the price of the share when that share is acquired.[11] The Commentary would then indicate that any subsequent increase in value would be a capital gain. An exception would be provided to deal with cases where an option has been exercised but where that option entitled the employee to acquire shares which will not irrevocably vest until the end of a period of required employment. In such a case, it would be appropriate to apply Article 15 to the increase in value, if any, until the end of the required period of employment that is subsequent to the exercise of the option.

25. The Commentary would also clarify that this interpretation only applies for purposes of the Convention and does not, therefore, require that taxation of the employment income under domestic law occur at the time of exercise. Thus, the State of source could tax at the time of granting, at the time of exercise (or disposal of the option) or at the time of sale of the share. [12] However, the State of source could tax only what can be considered to be an estimation of the true gain attributable to the option itself[13] and not what is attributable to the subsequent holding of shares acquired with the option. That interpretation would also not affect the characterisation of the stock-option benefit for domestic purposes. Thus, while Article 15 would be interpreted to allow the State of source to tax the benefit accruing up to the time of exercise of the option, it will be left to that State to decide how to tax such benefit, e.g. as either employment income or capital gain. The same will be true in the State of residence. For example, while that State will have sole taxation right on the increase of value of the share obtained after exercise since this will be considered to fall under Article 13 of the Convention, it may well decide to tax such increase as employment income rather than as a capital gain under its domestic law.

Difficulty in determining to which services the option relates

26. Subject to the exception of its paragraph 2, Article 15 allows the State of source to tax remuneration that is derived from services exercised therein. In many cases, it can be difficult to determine to which services the granting of a stock-option relates. Some may view the option as rewarding previous performance, others as an incentive for future performance.

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

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11. Plus the price of the option, in case the employee has paid an amount when acquiring that option.

12 . As indicated in paragraph 6 above, this is not intended to be an exhaustive list of events which can trigger taxation.

13 . In the case of shares that have not irrevocably vested (i.e. in the situation described in paragraph 2d) of the suggested guidelines in paragraph 29 below), the State of source could also tax under Article 15 the increase in value of the shares prior to the end of the restrictions that is subsequent to the exercise of the option.

Example: Employee E, who is currently a resident of State A, is an employee of a company Y, a resident of State A which has a permanent establishment in State B. From 1990 and until 31 December 1997, E worked in State A. In 1998, he worked in State B for the permanent establishment situated therein, without becoming a resident of State B for purposes of the State A-State B tax convention. On 1 January 1999, he came back to State A. On 31 March 1999, E receives a stock-option under company Y stock-option plan. Under that plan, options are given on 31 March each year to individuals who were employed throughout the previous year. Options are only granted if the company has made profits during the previous financial year. These options are valid for 5 years but may not be exercised within 24 months after they have been granted and are only irrevocably acquired by E if he remains an employee during that period of 24 months. On 20 June 2001, E exercises the option. At that time, State B decides to tax as employment income related to the 1998 taxation year the difference between the amount paid by E and the market value of the shares at that time. State A, however, considers that the stock-option does not relate to E's period of employment in State B.

28. In that situation, the conflict between States A and B can be seen as either a conflict of facts (the States disagree as to whether the option relates to the period of employment in State B or not) or of interpretation of Article 15 (the States disagree as to the meaning of the words (found in Article 15) "remuneration derived from employment exercised in a State"). In both cases, the principles developed in section III of the report on the Application of the Model Tax Convention to Partnerships to deal with conflicts of qualification would not resolve the issue since there is no agreement that the State of source has levied tax "in accordance with the provisions of the Convention".

Possible guidelines for determining services to which an option relates

29. One way of addressing this problem would be to provide, in the Commentary on Article 15, a general set of guidelines that could be applied on a case-by-case basis having regard to all the facts and circumstances including the relevant contractual arrangements. The following draft guidelines were developed by the Working Group during the course of its discussions:

1. The determination of the period of employment from which a particular employee stock-option is derived must be done in each case on the basis of all the relevant facts and circumstances, including the contractual conditions associated with that option (e.g. the conditions under which the option granted may be exercised or disposed of). The following general principles should help in making such a determination.

2. First, as a general rule, an employee stock-option should not be considered to relate to any services rendered after the period of employment that is required as a condition for the employee to acquire an irrevocable right to that option. Thus, where a stock-option is granted to an employee on the condition that he provides employment services to the same employer (or an associated enterprise) for a period of three years, the employment benefit derived from that option should generally not be attributed to services performed after that three-year period. In applying this principle, however, the following considerations need to be taken into account:

a) It is important to distinguish between a period of employment that is required to obtain the right to an employee stock-option and a period of time that is merely a delay before such option may be exercised (a blocking period). Thus, for example, an option that is granted to an employee on the condition that he remains employed by the same employer (or an associated enterprise) during a period of three years can be considered to be derived from the services performed during these three years while an option that is unconditionally granted to an employee on a given date but which, under its terms and conditions, can only be exercised after a delay of three years, should not be considered to relate to the employment performed during these years as the benefit of such an option would accrue to its recipient even if he were to leave his employment immediately after receiving it and waited the required three years before exercising it.

b) It is also important to distinguish between a situation where a period of employment is required as a condition for an option to irrevocably vest and a situation where an option that has already vested may be forfeited if it not exercised before employment is terminated (or within a short period after). In the latter situation, the benefit of the option should not be considered to relate to services rendered after vesting since the employee has already obtained the benefit and could in fact realise it at any time. A condition under which the option may be forfeited if employment is terminated is not a condition for the acquisition of the benefit but, rather, one under which the benefit already acquired may subsequently be lost.

c) There are exceptional cases where the principle might not apply. One such case could be where the equity-based remuneration right is granted irrevocably to an employee at the time he either takes up an employment, is transferred to a new country or is given significant new responsibilities and, in each case, the right clearly relates to the new functions to be performed by the employee during a specific future period. In that case, it may be appropriate to consider that the right relates to these new functions even if the right is irrevocably acquired before these are performed.

d) There are also cases where an option irrevocably vested technically but where that option entitles the employee to acquire shares which will not irrevocably vest until the end of a period of required employment. In such cases, it may be appropriate to consider that the benefit of the option relates to the services rendered in the whole period between the grant of the option and the vesting of the shares.

e) Where a period of employment is required to obtain the right to an employee's stock-option but such requirement is not applied in certain circumstances, e.g. where the employment is terminated by the employer or where the employee reaches retirement age, the equity-based remuneration should be considered to relate only to the period of services actually performed when these circumstances have in fact occurred.

3. Second, an employee stock-option should only be considered to relate to services rendered before the time when it is granted to the extent that such grant is conditional on such services having been performed by the recipient. This would be the case, for example, where the remuneration is demonstrably based on the employee's past performance during a certain period or is based on the employer's past financial results and is conditional on the employee having been employed by the employer or an associated enterprise during a certain period to which these financial results relate. Also, in some cases, there may be objective evidence demonstrating that during a period of past employment, there was a well-founded expectation among participants to an employee stock-option plan that part of their remuneration for that period would be provided through the plan by having stock-options granted at a later date. This evidence might include, for example, the consistent practice of an employer that has granted similar levels of stock-options over a number of years, as long as there was no indication that this practice might be discontinued. Depending on other factors, such evidence may be highly

relevant for purposes of determining if and to what extent the stock-option relates to such a period of past employment.

4. Third, there may be situations in which some factors may suggest that an employee stock-option is rewarding past services, but other factors seem to indicate that it relates to future services. In cases of doubt, it should be recognised that employee stock-options are generally provided as an incentive to future performance or as a way to retain valuable employees. Thus, employee stock-options are primarily related to future services. However, all relevant facts and circumstances will need to be taken into account before such a determination can be made and there may be cases where it can be shown that equity-based remuneration is related to combined specific periods of previous and future services (e.g. options are granted on the basis of the employee having achieved specific performance targets for the previous year, but they become exercisable only if the employee remains employed for another three years).

5. In order to avoid double taxation, States which reach different conclusions when applying the above principles to individual cases are encouraged to use the mutual agreement procedure in order to reach a common determination as to the period of employment services to which a particular stock-option relates or to provide guidance more generally as to common situations.

30. Where the employment services to which a stock-option relates have been provided in more than one State, an allocation rule is necessary for purposes of the application of Article 15 and Articles 23A and 23B.

31. A logical allocation method (which could be put forward in the Commentary on Article 15) would be to consider that the employment benefit attributable to a stock-option has to be attributed to services performed in a particular country in the proportion of the period when services are provided in that country to the whole period of services[14] to which the stock-option relates.

Example: An employee stock-option relates to a period of 3 years of employment. During year 1, the employee is a resident of State A (the country of which the employer is a resident) but provides services during 6 months in State B (his presence there exceeds 183 days, which gives that country source taxing rights) and during 1 month in State C (because the employee's presence does not exceed 183 days and the other conditions of paragraph 2 of Article 15 are fulfilled, State C does not have source taxing rights under Article 15 of the A-C treaty). During years 2 and 3, he is a resident of State D where he provides all his services.

32. In that case, 5/36 of the benefit should be allocated to the services rendered in State A, 6/36 to the services rendered in State B, 1/36 to the services rendered in State C and 24/36 to the services rendered in State D. This allocation applies for purposes of determining to what extent the stock-option benefit is derived from services rendered in each State. This is necessary for the purpose of determining the extent to which Article 15 gives taxing rights to the State of source as well as for the purpose of determining on what part of the benefit the State of residence must provide relief of double taxation under Article 23. However, while the allocation will be used for purposes of determining on which part of the income the State of residence is obliged to give credit, it will not operate to restrict the taxing rights of that State except, of course, if such restriction results from the fact that relief of double taxation is provided through

14 . For the purposes of that formula, the only periods of services that should be taken into account are those that are relevant for the stock-option plan, e.g. those during which services are rendered to the same employer or to other employers the employment by whom would be taken into account to satisfy a period of employment required to irrevocably acquire the option.

the exemption method. As explained in the section that deals with multiple residence taxation (see below), this allocation will not, therefore, be sufficient to avoid the double taxation that can result from timing mismatches in the taxation of stock-option by different States of residence.

33. While the allocation method described above would appear to be the most practical one, it may be possible to envisage that in exceptional cases, the competent authorities of two States may mutually agree to use another method, for instance a method based on the valuation of the stock-options at the beginning and the end of the period during which the employment services are provided in a given State. Comments are invited as to whether and when it would be appropriate to depart from the method of daily allocation.

Multiple residence taxation

34. While the preceding comments have focussed primarily on residence-source issues, situations where the benefits from employee stock-options are subject to tax in more than one State do not arise only, and maybe not primarily, because of the source and residence taxation of stock-options. Where an employee who is a resident of one State is taxed as a non-resident in another State, Article 23 provides relief from any double taxation. However, an employee might reside in different countries at the time an option is granted, the time it vests irrevocably, the time it is exercised and the time the shares acquired with the option are sold. All of these countries may claim the right to tax as States of residence and if each of them has a system that taxes the benefit from the stock-option at the time the taxpayer is a resident of that country,[15] there will be multiple residence taxation. While Article 23 deals with residence-source double taxation, it does not provide relief for all cases of residence-residence double taxation. The risks of multiple residence taxation may be compounded in the case of countries that have a "departure tax" on capital gains, i.e. countries that deem capital gains to be realised when a person ceases to be a resident or that maintain, through their tax conventions, a right to tax capital gains of former residents.

35. The example already used in paragraph 31 of the section entitled "Difficulty in determining to which services the option relates" may serve to illustrate the limits of the relief of double taxation provided by tax conventions in cases of residence-residence double taxation.

> *Example:* An employee stock-option relates to a period of 3 years of employment. During year 1, the employee is a resident of State A (the country of which the employer is a resident) but provides services during 6 months in State B (his presence there exceeds 183 days, which gives that country source taxing rights) and during 1 month in State C (because of the duration of the employee's presence and the residence of the employer, State C does not have source taxing rights under Article 15 of the A-C treaty). During years 2 and 3, he is a resident of State D where he provides all his services.

36. As already discussed, it would seem appropriate to consider that, in that case, 5/36 of the benefit should be allocated to the services rendered in State A, 6/36 to the services rendered in State B, 1/36 to the services rendered in State C and 24/36 to the services rendered in State D.

37. In the above example, State A will therefore be entitled, under each of the A-B, A-C and A-D treaties, to tax the whole of the employment benefit from the stock-option provided that it does so while

15 . As a general rule, a State will only tax an element of income on the basis of residence if the taxpayer is a resident of that State at the time when the income is considered to be derived by the taxpayer under the domestic tax law of that State.

the employee is a resident of State A. It will, however, be obliged to provide relief of double taxation as regards the taxation, by State B, of 6/36 of the benefit and the taxation, by State D, of 24/36 of the benefit (these parts correspond to the services rendered in these States for which Article 15 of the A-B and A-D treaties gives source taxing rights to these States). As a State of source, State B will only be entitled to tax 6/36 of the benefit under the A-B and B-D treaties. Both the A-C and C-D treaties will prevent State C from taxing any part of the benefit. Finally, under each of the A-D, B-D and C-D treaties, State D will be entitled to tax the whole of the benefit as a State of residence as long as it does so while the taxpayer qualifies as a resident of State D. In that case, State D will be obliged to provide relief of double taxation as regards the taxation, by State A, of 5/36 of the benefit and the taxation, by State B, of 6/36 of the benefit.

38. In this example, if State A taxes the employment benefit at grant while State D taxes it at exercise, State A will thus have taxed the whole benefit in year 1 while State D will have done the same in year 3. Article 15 of the A-D treaty will not restrict either State's right to tax any part of the benefit since the taxpayer is a resident of each State when that State considers the income to be derived and therefore applies the Article, i.e. at the time of grant (year 1) for State A and at the time of exercise (year 3) for State D.

39. Of course, Article 23 of the A-D convention will then require each State to provide relief of double taxation, through the credit or exemption method, as regards the tax that the other State has levied on the part of the employment benefit that relates to the services performed in that other State and which that other State has the right to tax as a State of source. Thus State A will be required to provide relief for the tax levied by State D on the part of the benefit that relates to the services rendered in State D in year 2 and 3 (24/36 of the benefit). Conversely, State D will be required to provide relief for the tax levied by State A on the part of the benefit that relates to services rendered in State A in year 1 (5/36 of the benefit).

40. The result will be that neither State A nor State D will provide relief for taxes levied in the other contracting state on the part of the benefit that relates to services provided in State B (6/36 of the benefit) or in State C (1/36 of the benefit). Since both State A and State D will themselves provide relief for tax levied by State B (the State of source), double taxation will arise with respect to the part of the benefit that relates to services rendered in State B only if both States A and D are credit countries and the tax levied by each on such benefit exceeds that levied by State B. The double taxation situation is more serious as regards State C. In that case, both States A and D have full taxation rights (as the State of residence) and, since State C is the State of source (with no source taxation rights), neither State A nor State D is required to provide relief for taxes levied in the other contracting state. Thus, there is full unrelieved double taxation by States A and D on the part of the benefit that relates to services rendered in State C.

> *Example:* 1) State B levies tax of $35 while State A and State D both levy $40 on the part of the benefit that relates to employment services rendered in State B. State A will provide $35 relief under the A-B treaty and State D will provide $35 relief under the B-D treaty. The employee will hence be taxed $45 ($35 + $40 + $40 - $35 - $35), with an unrelieved double tax of $5 (the overlap of the amounts of tax levied by State A and State D in excess of that levied by State B).
>
> 2) State C does not levy any tax on the part of the benefit that relates to employment services rendered in State C while State A and State D each levy $40 on that part of the benefit. State A will not provide any relief under the A-C treaty and State D will also not provide any relief under the D-C treaty. The employee will hence be taxed $80 ($40 + $40), with an unrelieved double tax of $40.

41. It could be argued that State D is required to provide relief for the tax levied by State A on the part of the benefit that relates to services rendered in States B and C because that tax has been levied by State A in accordance with the A-D Convention since nothing in that Convention prevents State A from taxing the employee on the basis of his residence when the option is granted. That interpretation, however,

produces an absurd result as it would similarly require State A to provide relief for the tax that State D has levied on the same part of the benefit. Clearly, an interpretation that requires each of the two Contracting States to provide relief for the other State's tax on the same income must be rejected.

Possible ways of addressing this issue

42. The example above shows that there are cases where Article 23 would not relieve residence-residence double taxation of the employment benefit arising from an employee stock-option. The mutual agreement procedure could, however, be used to deal with such cases. One possible basis to solve such cases would be for the competent authorities of the two States to agree that each State should provide relief as regards the residence-based tax that was levied by the other State on the part of the benefit that relates to services rendered during the period while the employee was a resident of that other State. Thus, in the above example, it would be logical for State D's competent authority to agree to provide relief (either through a credit or exemption method) for the State A's tax that has been levied on the part of the benefit that relates to services rendered in States B and C since, at the time when these services were rendered, the taxpayer was a resident of State A and not of State D for purposes of the A-D Convention. The Commentary could be modified to suggest that this approach provides a good basis to deal with cases of unrelieved residence-residence double taxation. It should be noted, however, that cases of multiple-residence taxation are not limited to the taxation of employee stock-options and it would be necessary to verify whether that approach would be appropriate in other cases.

Compliance issues

43. In practice, a significant part of the cross-border difficulties relating to ESOPs relates to compliance and administrative issues. Even if the various issues described above could be solved by clarifying what each country may tax and how relief of double taxation should be granted, this would still leave a significant administrative burden for tax administrations and a compliance burden on employees who reside or work successively in different countries. Taxing such employees requires tax administrations to properly determine to which services particular options relate and to take account of transactions in shares or options in foreign companies. As a number of countries and companies have experienced, options in shares of foreign parent companies granted to employees of local subsidiaries may give rise to significant administrative difficulties, particularly since the local employer, which is usually the information and collection point for salary taxation, may not be directly involved in the operation of the ESOP.

Possible ways of addressing this issue

44. A possible way to alleviate some of these administrative and compliance difficulties would be to achieve more effective information exchange in relation to ESOPs. Depending on the relevant domestic law, information may currently be required from the employer, the employee or the entity that operates an ESOP (which would typically have all the relevant information concerning a particular employee's participation in the plan, such as when the options are granted and exercised, what are their conditions etc). That information may be required from different persons and in different formats. Possible improvements with respect to exchange of information related to employee stock-options could therefore be examined in the context of the work being carried on by the Committee in the area of exchange of information.

45. Another way of alleviating these difficulties would be for tax administrations to make sure that their domestic rules applicable to the treatment of stock-options are clear and well understood by

employers. In many countries, the treatment of employee stock-options depends on the interpretation of general rules or principles. Tax administrations should make sure that their interpretation of such rules or principles is easily accessible to taxpayers.

Alienation of stock-options as a result of a merger or acquisition

46. Following a merger or acquisition, it is possible that options to acquire shares of a merged or acquired company are replaced by options to acquire shares in a successor or acquiror company. This may result in an alienation of the stock-options for the employee in either his State of residence, a State which has the right to tax these stock-options because they were granted in relation to an employment exercised therein or both States. An inconsistent treatment could result in a timing mismatch for purposes of the elimination of double taxation. Also, if a State does not consider that stock-options granted to a resident employee would be alienated in the case of a purely domestic merger or acquisition, it would seem logical to expect that a resident's employee's options to acquire shares in a foreign company would be similarly treated by that State in a purely foreign merger or acquisition.

> *Example:* Employee E, a resident of State A, has stock-options of company Y, a resident of State B. Company Y merges with company Z, also a resident of State B, to form new company YZ. In the process, all the stock-options of company Y are exchanged for stock-options of company YZ. While a domestic merger does not result in an alienation of the stock-options of resident employees in both States A and B, State A considers that the YZ merger results in an alienation of the stock-options that have been replaced.

Possible ways of addressing this issue

47. A few tax treaties include provisions dealing with mismatches arising from corporate reorganisations that have cross-border effects. While these provisions may not address stock-options, these provisions suggest that there are ways of dealing with situations where a corporate reorganisation results in the alienation of a stock-option in one State but not in the other. For example, to avoid such mismatches, provisions could be drafted to allow taxpayers to realise an alienation of the stock-option in a State where the corporate reorganisation would not trigger such an alienation or, conversely, to defer the alienation of a stock-option in the State where the corporate reorganisation would normally result in such an alienation.

Different valuation of a stock-option benefit where shares are quoted on different stock-exchanges

48. In many cases, shares are quoted on different stock-exchanges and the value of a share at a particular time may slightly vary on the two stock-exchanges when these values are converted at the exchange rates applicable at that time (such variations may result, for instance, from expectations related to the movement of currency exchange rates). This may translate into differences in the valuation of the employment benefit related to the stock-option, and of the capital gain realised when the shares are alienated, in the various countries where the shares are quoted. Related issues could arise in cases where there appears to be no gain (or a lesser gain) in the value of a share under the currency of one of the countries, while there appears to be a gain (or a greater gain) under the currency of the other country; in other words, part or all of the 'remuneration' represents what might be considered a pure exchange rate gain.

49. While this may result in compliance problems for the company that manages a world-wide employee stock-option plan, it is clear that the measurement of the remuneration related to employment is

a matter of domestic law and that each country is entitled to measure the employment benefit or capital gain related to a stock-option by reference to the domestic value of the option or the shares.

Issues related to the employer

50. This section briefly analyses some issues that may arise from ESOPs in relation to the application of tax treaties to the tax situation of the employer. While tax treaty issues that arise in relation to employees will naturally result in compliance issues for employers, those are merely consequential to the issues described in the preceding section and are therefore not dealt with in this section.

Deductibility of the costs of ESOPs

51. The deduction of costs related to running an ESOP (e.g. legal, financial and accounting costs related to the plan) does not raise particular difficulties, at least when these costs are incurred by the employer.[16] However, different views exist with respect to the question of whether and to what extent the benefit to the employee results in deductible expenses for the employer.

52. The question of allowing a deduction where shares are issued pursuant to a stock-option is, however, purely a matter of domestic tax policy. While it is true that the fact that countries' rules vary in that respect may create difficulties and possible compliance problems, this is just another example of mismatches resulting from differences between countries' rules for computing profits, a matter that is generally not dealt with in tax treaties.

Remuneration "borne by" a permanent establishment

53. The issue of the deduction of costs is, however, relevant for purposes of the application of paragraph 2c) of Article 15 of the OECD Model Tax Convention, i.e. to determine whether benefits are borne by a permanent establishment of the employer. Paragraph 7 of the Commentary on Article 15 indicates that the phrase "remuneration is not borne by a permanent establishment" must be interpreted to refer to remuneration that is not deductible in computing the profits of the permanent establishment. The fact that a State does not allow a deduction where shares are issued pursuant to a stock-option does not indicate that the costs of the remuneration paid in the form of stock-options are not deductible and therefore not borne by a permanent establishment in that State. States will normally allow a deduction for the costs associated with the management of a stock-option plan where these costs are shown to relate to employment services provided to a permanent establishment situated in that State. It may therefore be useful to expand paragraph 7 of the Commentary on Article 15 to clarify that remuneration in the form of stock-options must be considered to be borne by a permanent establishment even though a State takes the view that the issuing of shares pursuant to a stock-option does not involve deductible costs.

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16. The transfer issues that may arise when the costs are incurred by a company that is not the employer (e.g. ESOP at the level of the parent company) are not discussed in this note but are currently being examined by Working Party No. 6 (see the introduction).

ANNEX

GRAPHICAL ILLUSTRATION

Year:	**01**	**02**	**03**	**04**
Time:				
Event:	**attribution of option**	**end vesting period**	**exercise of option** (acquisition of share)	**sale of share**
Price:	price for option		strike price of share	
			market price of share acquired	market price of share sold
Value:	value of option at grant	value of option at end vesting period	value of option at exercise	
			value of share acquired	value of share sold