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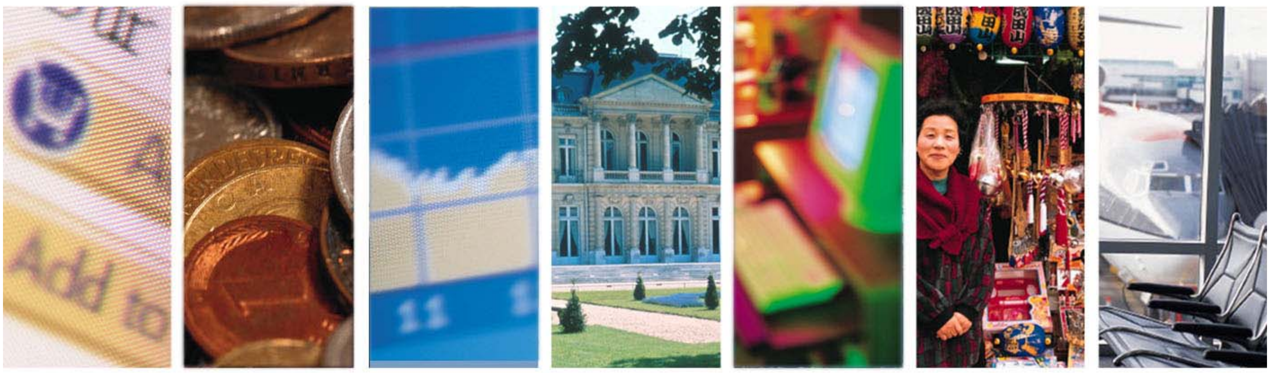

# Cross-border Income Tax Issues Arising from Employee Stock Option Plans

CTPA

CENTRE FOR TAX POLICY AND ADMINISTRATION

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

**REPORT APPROVED BY THE COMMITTEE ON FISCAL AFFAIRS**

In March 2002, the OECD Committee on Fiscal Affairs released a first public discussion draft on cross-border issues related to employee stock-options. The draft described tax treaty issues that may arise in the case of employee stock-options and included proposals on how to deal with these issues.

On the basis of the comments received on that first draft, the Committee produced a revised draft that included proposals for changes to the Commentary on the OECD Model Tax Convention. The revised draft was released for public comments in July 2003.

The Committee thanks the individuals and organisations that have sent comments on that revised discussion draft. Taking these comments into account, the Committee has now finalized its report. The report, which is attached, was approved by the Committee on 16 June 2004.

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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 presents changes to the Commentary on the OECD Model Tax Convention on how to deal with 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 not dealt with in this note.

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.

3. For purposes of this note, no distinction should be made between "in the money"[3] and "out of the 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.

4. This note does not deal with social security issues relative to stock-options. Also, valuation issues related to stock-options are only dealt with to a limited extent, i.e. primarily where there are related currency-exchange issues.

### Background on ESOPs

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

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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 . For purposes of this note, 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 at the time the option is granted. 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.

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| *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). Also, the option may be granted by the employer, an associated enterprise or an intermediary (such as a trust). 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. |
| *Benefit to the employee*[4] | 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.<br><br>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.[5]<br><br>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 make the evaluation far less reliable). Financial economists have designed formulae to determine the value of the option. These formulae may take into account various parameters (which may themselves need to be estimated): such as 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). |
| *Vesting of an option* | The concept of vesting is commonly used with respect to American options issued to employees. An option will generally be considered to have vested when all conditions for its exercise have been satisfied and the option can thus be exercised. |

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

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

Among the typical conditions that must be met before an employee can exercise the option that has been granted to him, it is frequently required that the employee continues to work for the employer during a certain period of time. To the extent that such a condition must be met before the option becomes exercisable, that condition has, in many countries, the legal nature of a condition precedent (common law) or suspensive condition (civil law). The option is not considered to have vested before such a condition has been met. In many countries, however, a condition subsequent (common law) or a resolutory condition (civil law) would not prevent the option from vesting. That would be the case, for example, of 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. When all conditions (such as that one) under which the option may be forfeited have disappeared, the option, which has already vested in the previous example, is said to have "irrevocably" vested. There is therefore an important difference between "vesting "and "irrevocable vesting"; when referring to the time when an option becomes exercisable or may be exercised, this note refers to the time of "vesting" and not to that of "irrevocable vesting".

The concept of vesting creates difficulties as regards European options to the extent that such options do not become exercisable before the expiration date of the option i.e. the date when the option must be exercised (and will be lost if not exercised at that date).[6] For the purposes of this note, it is important to distinguish between a period of employment that is required to obtain the right to exercise an employee stock-option and a period of time that is merely a delay before such option may be exercised (a blocking period). An option should be considered to have vested as soon as all the conditions necessary for the exercise of the option have been met and the right to exercise the option can no longer be forfeited, even if the option is only exercisable at a later date. Thus, for the purpose of this note, a European option should be considered to have vested from the moment employment is no longer required (provided that the other conditions have been satisfied), even if the option may only be exercised at a later date. Where, however, it is provided that the option will be forfeited if the employment is terminated before the date on which the option may be exercised, the option will not, for purposes of this revised draft, be considered to have vested before that date.

**Issues related to the employee**

***Timing mismatch in taxing the employment benefit***

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

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6 . A similar issue will arise with respect to an American option if there is a time gap between the moment when all the conditions attached to the option have been met (so that the right to exercise it at a later date can no longer be forfeited) and the beginning of the period during which it can be exercised.

7. 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 vests or irrevocably vests;
- 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[8].

8. 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 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).

9. 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).

10. This timing difference may also result 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.

11. The following example may be used to illustrate the problems arising from taxation at different times:

> *Example:* Employee E, who is 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.

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. 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.

12. 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)?

13. 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, State A (the State of residence) must recognise State B's (the State of source) right to tax the benefit under the sourcing rules of the convention entered into by these two States. The rules of the convention concerning elimination of double taxation (if they are based on the OECD Model) will then effectively require State A to exempt or to give a credit even if its domestic law sources the income differently (as explained in section III of the report on the Application of the OECD Model Tax Convention to Partnerships).

14. As explained in the previous paragraphs, the different country rules for taxing stock-options 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.

15. The problem of relieving double taxation when the States of residence and source do not tax stock-options at the same time is partly addressed by the fact that the application of the relief of double taxation provisions of the OECD Model Convention is not restricted in time, i.e. relief must be given even if the State of residence taxes at a different time than the State of source. This, however, may not 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.

16. The other issue discussed in paragraph 10 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). That issue is discussed in the section below.

17. Based on that analysis, the Committee concluded that the following changes should be made to the Commentary on the Model Tax Convention:

*Add the following paragraph 2.2 to the Commentary on Article 15:*

"2.2 The condition provided by the Article for taxation by the State of source is that the salaries, wages or other similar remuneration be derived from the exercise of employment in that State. This applies regardless of when that income may be paid to, credited to or otherwise definitively acquired by the employee."

*Add the following heading and paragraphs 12 and 12.1 to the Commentary on Article 15:*

"**The treatment of employee stock-options**

12. The different country rules for taxing employee stock-options create particular problems which are discussed below. While many of these problems arise with respect to other forms of employee remuneration, particularly those that are based on the value of shares of the employer or a related company, they are particularly acute in the case of stock-options. This is largely due to the fact that stock-options are often taxed at a time (e.g. when the option is exercised or the shares sold) that is different from the time when the employment services that are remunerated through these options are rendered.

12.1 As noted in paragraph 2.2, the Article allows the State of source to tax the part of the stock-option benefit that constitutes remuneration derived from employment exercised in that State even if the tax is levied at a later time when the employee is no longer employed in that State."

*Add the following paragraph 32.8 to the Commentary on Articles 23 A and 23 B:*

**F. Timing Mismatch**

"32.8 The provisions of the Convention that allow the State of source to tax particular items of income or capital do not provide any restriction as to when such tax is to be levied (see, for instance, paragraph 2.2 of the Commentary on Article 15). Since both Articles 23 A and 23 B require that relief be granted where an item of income or capital may be taxed by the State of source in accordance with the provisions of the Convention, it follows that such relief must be provided regardless of when the tax is levied by the State of source. The State of residence must therefore provide relief of double taxation through the credit or exemption method with respect to such item of income or capital even though the State of source taxes it in an earlier or later year. Some States, however, do not follow the wording of Article 23A or 23B in their bilateral conventions and 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 (the mutual agreement procedure, for example) to relieve the double taxation which might otherwise arise in cases where the State of source levies tax in a different taxation year."

***Distinguishing employment income from capital gains***

18. 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).[9] 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, some commentators have considered that the holding and subsequent exercise of the option constitute investment decisions and that the gain represented by the difference between the value of the option at the time it is exercised and the value of the option at the time it was granted constitutes a capital gain falling under Article 13, which does not allow source taxation of the gain, rather than under Article 15, which would. Others have suggested that this analysis should only apply to the part of the gain that accrues after the option has vested since the employee cannot make an investment decision to keep or exercise the option before that time. It has also been suggested, however, that any benefit derived from the

9. 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.

option, including any gain realised upon the sale of shares acquired with that option, should be considered as employment income as the employee exercised the option and acquired the share solely because he was remunerated with that option.

19. If countries were to adopt different interpretations on this matter, the resulting conflicts of interpretation would create double taxation or dual exemption situations. Apart from this possible conflict of interpretation, a conflict of qualification[10] 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 could 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 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 benefit 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 or on replacement of the option).

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 all or at least part of that benefit as employment income.

22. The fact that a large number of countries 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 shares at that time and the amount paid by the employee to acquire them), indicates that these countries consider that, for the purposes of Articles 13 and 15, the dividing line is the moment when the option is exercised and the employee becomes a shareholder.

23. The Committee agreed that this view derived from the practice followed by many countries was the most appropriate one. Not only is it practical to adopt the date of exercise as the dividing line between employment income and capital gain but it also appears right to consider that the employee should be treated as an investor only from the time that he acquires the quality of shareholder and invests money in order to do so. The Committee therefore agreed that any benefit accruing in relation to the stock-option up to the time when the option is exercised, sold or otherwise alienated should be treated as income from employment to which Article 15 applies.

24. The Committee also agreed that the benefits resulting from an employee stock-option could not, as a general rule, fall under either Article 21 or Article 18 even if the option was exercised after termination of the employment or retirement. Article 21, by its residual nature, will not apply since either Article 13 or 15 will apply. Article 18 deals only with pensions and other similar remuneration and these

10 . The difference between these types of conflict is explained in paragraph 32.5 of the Commentary on Articles 23 A and 23 B of the OECD Model Tax Convention.

words do not cover employee stock-options. Thus, for instance, if an option that became exercisable before an employee retired is exercised after that employee’s retirement, Article 18 will not apply to the benefit derived from the option.

25. The following example illustrates the conclusions reached by the Committee:

*Example*: Employee E is resident and working in State A on 1 January 1998. He is granted an option to purchase shares for a price of 1, conditional on remaining in that employment at least until 1 January 2001. On 31 December 1999 he moves to work in State B, where he becomes a resident. He exercises the option on 1 January 2001 when the market value of the shares acquired is 7 but does not sell any shares until 31 December 2002, when the market value is 9. Both State A and State B tax at exercise and State B also taxes when the shares acquired are sold.

The gain that arises between the grant of the option and the date of vesting and exercise, i.e. 6, should be regarded as income from employment covered by Article 15. State A may tax the part of the stock option benefit that was derived from employment carried on there. If each working year is 260 days, then State A may tax 2/3 of this gain, i.e. 4 (this results from the conclusions presented in the section below which deals with the determination of the employment services to which the option relates). State B should provide relief for this tax, either by an exemption or credit method. But once the stock option has been exercised, then the employee is in the same position as any other shareholder. The gain that relates to the period between acquisition and sale of the shares acquired under the option will fall under Article 13 and State B, as the State of residence, will therefore have sole taxing rights on this gain.

26. The Committee therefore decided that these conclusions should be incorporated in the Model Tax Convention through the following changes:

*Add the following paragraph 32 to the Commentary on Article 13:*

"32. There is a need to distinguish the capital gain that may be derived from the alienation of shares acquired upon the exercise of a stock-option granted to an employee or member of a board of directors from the benefit derived from the stock-option that is covered by Articles 15 or 16. The principles on which that distinction is based are discussed in paragraphs 12.2 to 12.5 of the Commentary on Article 15 and paragraph 3.1 of the Commentary on Article 16."

*Replace paragraph 2.1 of the Commentary on Article 15 by the following (changes to the existing text appear in **bold italics**):*

"2.1. Member countries have generally understood the term "salaries, wages and other similar remuneration" to include benefits in kind received in respect of an employment (e.g. ***stock-options***, the use of a residence or automobile, health or life insurance coverage and club memberships). "

*Add the following paragraphs 12.2 to 12.5 to the Commentary on Article 15:*

“12.2 While the Article applies to the employment benefit derived from a stock-option granted to an employee regardless of when that benefit is taxed, there is a need to distinguish that employment benefit from the capital gain that may be derived from the alienation of shares acquired upon the exercise of the option. This Article, and not Article 13, will apply to any benefit derived from the option itself until it has been exercised, sold or otherwise alienated (e.g. upon cancellation or acquisition by the employer or issuer). Once the option is exercised or alienated, however, the employment benefit has been realized and any subsequent gain on the acquired shares (i.e. the value of the shares that accrues after exercise) will be derived by the employee in his capacity of investor-shareholder and will be covered by Article 13. 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). Where, however, the option that has been exercised entitles the employee to acquire shares that will not irrevocably vest until the end of a period of required employment, it will be appropriate to apply this Article to the increase in value, if any, until the end of the required period of employment that is subsequent to the exercise of the option.

12.3 The fact that the Article does not apply to a benefit derived after the exercise or alienation of the option does not imply in any way that taxation of the employment income under domestic law must occur at the time of that exercise or alienation. As already noted, the Article does not impose any restriction as to when the relevant income may be taxed by the State of source. Thus, the State of source could tax the relevant income at the time the option is granted, at the time the option is exercised (or alienated), at the time the share is sold or at any other time. The State of source, however, may only tax the benefits attributable to the option itself and not what is attributable to the subsequent holding of shares acquired upon the exercise of that option (except in the circumstances described in the last sentence of the preceding paragraph).

12.4 Since paragraph 1 must be interpreted to apply to any benefit derived from the option until it has been exercised, sold or otherwise alienated, it does not matter how such benefit, or any part thereof, is characterized for domestic tax purposes. As a result, whilst the Article will be interpreted to allow the State of source to tax the benefits accruing up to the time when the option has been exercised, sold or otherwise alienated, it will be left to that State to decide how to tax such benefits, e.g. as either employment income or capital gain. If the State of source decides, for example, to impose a capital gains tax on the option when the employee ceases to be a resident of that country, that tax will be allowed under the Article. The same will be true in the State of residence. For example, while that State will have sole taxation right on the increase of value of the share obtained after exercise 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.

12.5 The benefits resulting from a stock-option granted to an employee will not, as a general rule, fall under either Article 21, which does not apply to income covered by other Articles, or Article 18, which only applies to pension and other similar remuneration, even if the option is exercised after termination of the employment or retirement."

***Difficulty in determining to which services the option relates***

27. Subject to the exception in 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. In some cases, an option may be regarded as rewarding previous performance, in others as an incentive for future performance.

28. 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.

*Example:* Employee E, who is 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.

29. 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".

30. The Committee discussed extensively how this issue should be handled and concluded that the best approach that could be achieved would be to provide, in the Commentary on Article 15, a general set of principles that could be applied based on the facts and circumstances of each case, including the relevant contractual arrangements. It therefore decided to add the following paragraphs 12.6 to 12.13 to the Commentary on Article 15:

"12.6 Paragraph 1 allows the State of source to tax salaries, wages and other similar remuneration derived from employment exercised in that State. The determination of whether and to what extent an employee stock-option is derived from employment exercised in a particular State 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 be followed for that purpose.

12.7 The first principle is that, 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 the right to exercise 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.

12.8 In applying the above principle, however, it is important to distinguish between a period of employment that is required to obtain the right to exercise 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 granted, without any condition of subsequent employment, 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.

12.9 It is also important to distinguish between a situation where a period of employment is required as a condition for the acquisition of the right to exercise an option, i.e. the vesting of the option, and a situation where an option that has already vested may be forfeited if it is 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 vested 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. The following examples illustrate this distinction:

- Example 1: On 1 January of year 1, a stock-option is granted to an employee. The acquisition of the option is conditional on the employee continuing to be employed by the same employer until 1 January of year 3. The option, once this condition is met, will be exercisable from 1 January of year 3 until 1 January of year 10 (a so-called "American" option).[11] It is further provided, however, that any option not previously exercised will be lost upon cessation of employment. In that example, the right to exercise that option has been acquired on 1 January of year 3 (i.e. the date of vesting) since no further period of employment is then required for the employee to obtain the right to exercise the option.

- Example 2: On 1 January of year 1, a stock-option is granted to an employee. The option is exercisable on 1 January of year 5 (a so-called "European" option). The option has been granted subject to the condition that it can only be exercised on 1 January of year 5 if employment is not terminated before that date. In that example, the right to exercise that option is not acquired until 1 January of year 5, which is the date of exercise, since employment until that date is required to acquire the right to exercise the option (i.e. for the option to vest).

12.10 There are cases where that first principle might not apply. One such case could be where the stock-option is granted without any condition 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 option 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 option relates to these new functions even if the right to exercise the option is acquired before these are performed. There are also cases where an option vested technically but where that option entitles the employee to acquire shares which will not 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.

11 Under an "American" stock-option, the right to acquire a share may be exercised during a certain period (typically a number of years) while under a "European" stock-option, that right may only be exercised at a given moment (i.e. on a particular date).

12.11 The second principle is that 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 intended to reward the provision of such services by the recipient for a specific period. 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 the specific period to which these financial results relate. Also, in some cases, there may be objective evidence demonstrating that during a specific 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.

12.12 Where a period of employment is required to obtain the right to exercise 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 stock-option benefit should be considered to relate only to the period of services actually performed when these circumstances have in fact occurred.

12.13 Finally, 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 a stock-option 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)."

***Employment services that are provided in more than one State***

31. 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.

32. A logical allocation method 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

number of days during which employment has been exercised[12] in that country to the total number of days during which the employment from which the stock-option is derived has been exercised. [13]

> *Example:* An employee stock-option relates to a period of 3 years of employment (each year has 220 working days). During year 1, the employee is a resident of State A (the country of which the employer is a resident) but provides services during 110 days in State B (his presence there exceeds 183 days, which gives that country source taxing rights) and during 20 days 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.

33. In that case, 90/660 of the benefit should be allocated to the services rendered in State A, 110/660 to the services rendered in State B, 20/660 to the services rendered in State C and 440/660 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. Any part of the benefit that is allocated to services rendered in a State that is precluded from taxing under paragraph 2 of Article 15 of the Convention (e.g. State C in the above example) will therefore not be considered to be attributable to services rendered in another State (e.g. State A, B or D in the example) even if it cannot be taxed in the State to which it is attributed. 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 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-options by different States of residence.

34. The Committee agreed that the above allocation method would be the most appropriate one. It therefore decided to add the following paragraph 12.14 to the Commentary on Article 15:

> "12.14 Where, based on the preceding principles, a stock-option is considered to be derived from employment exercised in more than one State, it will be necessary to determine which part of the stock-option benefit is derived from employment exercised in each State for purposes of the application of the Article and of Articles 23A and 23B. In such a case, the employment benefit attributable to the stock-option should be considered to be derived from a particular country in proportion of the number of days during which employment has been exercised in that country to the total number of days during which the employment services from which the stock-option is derived has been exercised. For that purpose, the only days of employment that should be taken into account are those that are relevant for the stock-option plan, e.g. those during which services are rendered to the same employer or to other employers the employment by whom would be taken into account to satisfy a period of employment required to acquire the right to exercise the option."

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

13. Where stock-options vest incrementally, e.g. 25% per year over 4 years under the condition that the employee worked with the company throughout the relevant period, the determination of the relevant period of services needs to be done separately for each vesting period.

35. The following two examples illustrate the effect of this paragraph :

*Example 1*: Employee E is resident and working in State A on 1 January 1998. He is granted an option to purchase shares for a price of 1, conditional on remaining in that employment until at least 1 January 2001. On 31 December 1999 he moves to work in State B, of which he becomes a resident. He exercises the option on 1 July 2001 when the market value of the shares acquired is 8 and sells all the shares so acquired immediately. The benefit from the stock option should be regarded as income from employment covered by Article 15. State A may tax the part of the stock option benefit that was derived from employment carried on there, but only as a proportion of those days that were relevant for the stock option plan. If each working year is 260 days, then the days relevant to the stock option plan total 780 (3 x 260). State A may tax 520 (2 x 260) days of this as deriving from employment carried on there, i.e. 66.7% and State B may tax 260 days as deriving from employment exercised in State B. The remaining 130 days of employment between the date of vesting and exercise were not relevant to the stock option plan and are therefore ignored.

*Example 2:* Employee E is resident and working in State A on 1st January 1998. He is granted an option to purchase shares for a price of 1, conditional on remaining in that employment until at least 1st January 2001. On 31st December 1999 he moves to work in State B. Due to ill health, he terminates his employment on 30th June 2000 but is allowed to keep the option. He actually exercises it on 1st January 2001 when the market value is 7. If each working year is 260 days, then the days relevant to the stock option plan total only 650 (2½ x 260) and this is the whole period of employment. State A may tax 520 (2 x 260) days out of this total 650 as deriving from employment carried on in State A, i.e. 80%.

36. The Committee also agreed that Contracting States should be free to agree bilaterally to adopt other approaches for the determination of whether and to what extent a particular employee stock-option is derived from employment services rendered in a particular State, keeping in mind that such departures may create difficulties in situations where other States are involved. It therefore decided to add the following paragraph 12.15 to the Commentary on Article 15:

"12.15 It is possible for Member countries to depart from the case-by-case application of the above principles (in paragraphs 12.7 to 12.14) by agreeing to a specific approach in a bilateral context. For example, two countries that tax predominantly at exercise of an option may agree, as a general principle, to attribute the income from an option that relates primarily to future services to the services performed by an employee in the two States between date of grant and date of exercise. Thus, in the case of options that do not become exercisable until the employee has performed services for the employer for a specific period of time, two States could agree to an approach that attributes the income from the option to each State based on the number of days worked in each State by the employee for the employer in the period between date of grant and date of exercise. Another example would be for two countries that have similar rules for the tax treatment of employee stock-options to adopt provisions that would give to one of the Contracting States exclusive taxation rights on the employment benefit even if a minor part of the employment services to which the option relates have been rendered in the other State. Of course, Member countries should be careful in adopting such approaches because they may result in double taxation or double non-taxation if part of the employment is exercised in a third State that does not apply a similar approach."

### *Multiple residence taxation*

37. 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, 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,[14] 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.

38. The example already used in 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 (each year has 220 working days). During year 1, the employee is a resident of State A (the country of which the employer is a resident) but provides services during 110 days in State B (his presence there exceeds 183 days, which gives that country source taxing rights) and during 20 days 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.

39. As already discussed, it would seem appropriate to consider that, in that case, 90/660 of the benefit should be allocated to the services rendered in State A, 110/660 to the services rendered in State B, 20/660 to the services rendered in State C and 440/660 to the services rendered in State D.

40. 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 the employee is a resident of State A (which it will do if it taxes at grant). In that case, however, it will be obliged to provide relief of double taxation as regards the taxation, by State B, of 110/660 of the benefit and the taxation, by State D, of 440/660 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 110/660 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 90/660 of the benefit and the taxation, by State B, of 110/660 of the benefit.

41. 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

14 . 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.

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.

42. 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 (440/660 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 (90/660 of the benefit).

43. 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 (110/660 of the benefit) or in State C (20/660 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.

44. 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.

45. 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.

46. The Committee agreed that the Commentary should be modified to recommend that approach to deal with cases of unrelieved residence-residence double taxation. It therefore decided to add the following paragraphs 4.1 to 4.3 the Commentary on Articles 23 A and 23 B:

> "4.1 Article 4, however, only deals with cases of concurrent full liability to tax. The conflict in case *a*) may therefore not be solved if the same item of income is subject to the full liability to tax of two countries but at different times. The following example illustrates that problem. Assume that a resident of State R1 derives a taxable benefit from an employee stock-option that is granted to that person. State R1 taxes that benefit when the option is granted. The person subsequently becomes a resident of State R2, which taxes the benefit at the time of its subsequent exercise. In that case, the person is taxed by each State at a time when he is a resident of that State and Article 4 does not deal with the issue as there is no concurrent residence in the two States.
>
> 4.2 The conflict in that situation will be reduced to that of case *b*) and solved accordingly to the extent that the employment services to which the option relates have been rendered in one of the Contracting States so as to be taxable by that State under Article 15 because it is the State where the relevant employment is exercised. Indeed, in such a case, the State in which the services have been rendered will be the State of source for purposes of elimination of double taxation by the other State. It does not matter that the first State does not levy tax at the same time (see paragraph 32.8). It also does not matter that the other State considers that it levies tax as a State of residence as opposed to a State of source (see the last sentence of paragraph 8).
>
> 4.3 Where, however, the relevant employment services have not been rendered in either State, the conflict will not be one of source-residence double taxation. The mutual agreement procedure could be used to deal with such a case. One possible basis to solve the case 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, if the relevant services were rendered in a third State before the person became a resident of State R2, it would be logical for the competent authority of State R2 to agree to provide relief (either through the credit or exemption method) for the State R1 tax that has been levied on the part of the employment benefit that relates to services rendered in the third State since, at the time when these services were rendered, the taxpayer was a resident of State R1 and not of State R2 for purposes of the convention between these two States."

***Compliance issues***

47. 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.

48. One particular problem to which enterprises are sometimes confronted is the requirement to withhold tax at source in two or more jurisdictions on the same or similar employment benefit resulting from a stock-option. For example, if an employee has worked in two different countries during the period of services to which a stock-option relates, it may be that each of these countries will require the employer to withhold tax on the whole amount of the difference between the value of the underlying share and the exercise price when the option is exercised by the employee.

49. The compliance difficulties related to employee stock-options may be partly reduced by tax administrations making 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.

50. The problem described above in relation to withholding requirements can be alleviated if countries allow enterprises to adjust the amount of tax to be withheld to take account of any relief that will likely be available to the employee on account of double taxation as well as any relief provided for under a tax treaty. Since a majority of countries tax the employment benefit derived from an employee stock-option at exercise (or later), it would be possible to determine, at that point in time, whether or not some of the employment services to which the option relates have been rendered in one or more other countries so as to give rise to relief. Since the amount of tax to be paid in any such other country will probably not be determined at that time, it will not be possible to determine exactly how much relief for double taxation should be given by the State of residence that eliminates double taxation through the credit method. A reasonable approximation of the relief could, however, be used for purposes of the withholding tax requirements applicable at that time since, in this case, the employer of a State that taxes at exercise will know what is the period of time to which the employment benefit derived from the option relates and will also know, from the records kept for domestic wages tax purposes, the periods spent working overseas.

***Alienation of stock-options as a result of a merger or acquisition and replacement of options***

51. 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.

52. A similar issue may arise when an option is replaced by another option or when substantial changes are made to the conditions attached to the option and the employee to which the original option was granted has moved to another country before such replacement or changes. Apart from the issue of the period of services covered by the replacement option (which is dealt with above), the replacement or changes may trigger an alienation of the option in one country but not in the other, with a possible risk of double taxation.

53. As long as States agree that the new or modified option replaces the previous one for purposes of determining to which period of employment services it relates, they should also agree that the two options should be treated as one for purposes of relief of double taxation. Thus, each State should consider that the tax paid to the other State on the employment benefit derived from either the original or the new or modified option is tax paid on the same option even if these States levy the tax at different times.

***Valuation issues***

54. An issue can arise from 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. That should not be a problem for the computation of the employment benefit derived from an employee stock-option as that benefit is typically computed based on a single transaction and the benefit can then be translated into another currency using a single exchange rate. The problem may arise, however, for the computation of the capital gain derived from the alienation of the shares or for the computation of any gain that would require the valuation of the option at two different times between which there may have been currency fluctuations. That problem, however, is a typical problem related to the computation of capital gains and is not specific to employee stock-options (see paragraphs 16 and 17 of the Commentary on Article 13).

***The granting of stock-options to members of a board of directors***

55. Article 16 of the Model Tax Convention provides that "[d]irectors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State." Since the rules of Article 15 are drafted "subject to" those of Article 16, it is the latter Article that will apply to payments which are made to a director in his capacity as such notwithstanding the fact that, under the domestic law of certain States, a director of a company could conceivably be considered to be an employee of that company.

56. Thus, to the extent that stock-options are granted to a director in his capacity as such (as opposed to those which may be granted to the director by reason of employment functions exercised in another capacity), Article 16 clearly gives taxation rights to the State of residence of the company. Since the State of residence of the director will also have taxing rights (subject to providing relief of double taxation), many of the issues previously discussed in this note will also arise with respect to such options:

- to the extent that the State of residence of the director and the State of residence of the company may tax the benefit of the option at different times, the issues discussed under the section " timing mismatch in taxing the employment benefit" will potentially arise and should be dealt with as recommended in that section;
- the principles put forward in this note for distinguishing employment income from capital gains will equally be relevant for distinguishing director's fees and similar payments from capital gains;
- because the taxing rights allocated to the state of residence of the company under Article 16 do not depend on services being rendered in that State and extend to the whole of the benefit derived from a stock-option that can be considered to constitute directors' fees or similar

payments, there will be no need to identify services to which the option may relate or to allocate the benefit between various countries in which services have been performed;

- the previously-discussed issues related to multiple residence taxation, compliance, valuation and alienation as a result of a merger, acquisition or replacement will also potentially arise in the case of stock-options granted to directors and should be dealt with as recommended in the relevant sections of this note.

57. For these reasons, the Committee decided to make the following changes to the Commentary on Article 16:

*Replace paragraph 1.1 of the Commentary on Article 16 by the following (additions to the existing text appear in **bold italics**)*

"1.1 Member countries have generally understood the term "fees and other similar payments" to include benefits in kind received by a person in that person's capacity as a member of the board of directors of a company (e.g. ***stock-options***, the use of a residence or automobile, health or life insurance coverage and club memberships)."

*Add the following paragraph 3.1 to the Commentary on Article 16:*

"3.1 Many of the issues discussed under paragraphs 12 to 12.15 of the Commentary on Article 15 in relation to stock-options granted to employees will also arise in the case of stock-options granted to members of the board of directors of companies. To the extent that stock-options are granted to a resident of a Contracting State in that person's capacity as a member of the board of directors of a company which is a resident of the other State, that other State will have the right to tax the part of the stock-option benefit that constitutes director's fees or a similar payment (see paragraph 1.1. above) even if the tax is levied at a later time when the person is no longer a member of that board. While the Article applies to the benefit derived from a stock-option granted to a member of the board of directors regardless of when that benefit is taxed, there is a need to distinguish that benefit from the capital gain that may be derived from the alienation of shares acquired upon the exercise of the option. This Article, and not Article 13, will apply to any benefit derived from the option itself until it has been exercised, sold or otherwise alienated (e.g. upon cancellation or acquisition by the company or issuer). Once the option is exercised or alienated, however, the benefit taxable under this Article has been realized and any subsequent gain on the acquired shares (i.e. the value of the shares that accrues after exercise) will be derived by the member of the board of directors in his capacity of investor-shareholder and will be covered by Article 13. Indeed, it is at the time of exercise that the option, which is what the director obtained in his capacity as such, disappears and the recipient obtains the status of shareholder (and usually invests money in order to do so)."

**Issues related to the employer**

58. 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***

59. 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.[15] 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.

60. 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***

61. 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. That paragraph should not be read as suggesting that remuneration paid in the form of stock-options cannot be viewed as borne by a permanent establishment merely because the State in which a permanent establishment is located does not allow a deduction where shares are issued pursuant to employee stock-options. In such a case, the absence of a deduction results from the nature of the payment and not from the fact that the payment is not incurred in relation to the permanent establishment. The fact that such a State will normally allow a deduction for the costs associated with the management of the stock-option plan where these costs are shown to relate to employment services provided to a permanent establishment situated in that State indicates that the conditions of paragraph 2 c) will be met in relation to that remuneration. In order to clarify that point, the Committee recommends that paragraph 7 of the Commentary on Article 15 be amended as follows (changes appear in ***bold italics*** for additions and ***strikethrough*** for deletions):

> "7. Under the third condition, if the employer has ***a permanent establishment*** in the State in which the employment is exercised~~ a permanent establishment~~, the exemption is given ~~only ~~on condition that the remuneration is not borne by ***that*** ~~a ~~permanent establishment ~~which he has in that State~~. The phrase "borne by" must be interpreted in the light of the underlying purpose of subparagraph *c*) of the Article, which is to ensure that the exception provided for in paragraph 2 does not apply to remuneration that ~~is deductible~~***could give rise to a deduction***, having regard to the principles of Article 7 ***and the nature of the remuneration***, in computing the profits of a permanent establishment situated in the State in which the employment is exercised. In this regard, it must be noted that the fact that the employer has, or has not, actually ~~deducted the~~ ***claimed a deduction for the*** remuneration in computing the profits attributable to the permanent establishment is not necessarily conclusive since the proper test is whether ***any deduction otherwise available for that remuneration would be allocated to the permanent establishment***~~the remuneration would be allowed as a deduction for tax purposes;~~. ***That*** ~~that ~~test would be met, for instance, even if no amount were actually deducted as a result of the permanent establishment being exempt from tax in the source country or of the employer simply deciding not to claim a deduction to which he was entitled. ***The test would also be met where the remuneration is not deductible merely because of its nature (e.g. where the State takes the view that the issuing of shares pursuant to an employee stock-option does not give rise to a deduction) rather than because it should not be allocated to the permanent establishment."***

15. The transfer pricing 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.

**ANNEX 1**

**GRAPHICAL ILLUSTRATION**

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

## ANNEX 2

## CHANGES TO THE OECD MODEL TAX CONVENTION

The following are the changes to the Commentary to the Model Tax Convention resulting from this note (changes to the existing text of the Commentary appear in ***bold italics*** for additions and ***strikethrough*** for deletions):

***Commentary on Article 13***

1. Add the following paragraph 32 to the Commentary on Article 13:

***"32. There is a need to distinguish the capital gain that may be derived from the alienation of shares acquired upon the exercise of a stock-option granted to an employee or member of a board of directors from the benefit derived from the stock-option that is covered by Articles 15 or 16. The principles on which that distinction is based are discussed in paragraphs 12.2 to 12.5 of the Commentary on Article 15 and paragraph 3.1 of the Commentary on Article 16."***

***Commentary on Article 15***

2. Replace paragraph 2.1 of the Commentary on Article 15 by the following:

"2.1. Member countries have generally understood the term "salaries, wages and other similar remuneration" to include benefits in kind received in respect of an employment (e.g. ***stock-options***, the use of a residence or automobile, health or life insurance coverage and club memberships)."

3. Add the following paragraph 2.2 to the Commentary on Article 15:

***"2.2 The condition provided by the Article for taxation by the State of source is that the salaries, wages or other similar remuneration be derived from the exercise of employment in that State. This applies regardless of when that income may be paid to, credited to or otherwise definitively acquired by the employee."***

4. Replace paragraph 7 of the Commentary on Article 15 by the following:

"7. Under the third condition, if the employer has ***a permanent establishment*** in the State in which the employment is exercised~~ a permanent establishment~~, the exemption is given ~~only ~~on condition that the remuneration is not borne by ***that*** ~~a ~~permanent establishment ~~which he has in that State~~. The phrase "borne by" must be interpreted in the light of the underlying purpose of subparagraph *c*) of the Article, which is to ensure that the exception provided for in paragraph 2 does not apply to remuneration that ~~is deductible~~***could give rise to a deduction***, having regard to the principles of Article 7 ***and the nature of the remuneration***, in computing the profits of a permanent establishment situated in the State in which the employment is exercised. In this regard, it must be noted that the fact that the employer has, or has not, actually ~~deducted the~~ ***claimed a deduction for the*** remuneration in computing the profits attributable to the permanent establishment is not necessarily conclusive since the proper test is whether ***any deduction otherwise available for that remuneration would be allocated to the permanent***

***establishment***~~the remuneration would be allowed as a deduction for tax purposes;~~. ***That*** ~~that~~ test would be met, for instance, even if no amount were actually deducted as a result of the permanent establishment being exempt from tax in the source country or of the employer simply deciding not to claim a deduction to which he was entitled. ***The test would also be met where the remuneration is not deductible merely because of its nature (e.g. where the State takes the view that the issuing of shares pursuant to an employee stock-option does not give rise to a deduction) rather than because it should not be allocated to the permanent establishment."***

5. Add the following heading and paragraphs 12 to 12.15 to the Commentary on Article 15:

***"The treatment of employee stock-options***

***12. The different country rules for taxing employee stock-options create particular problems which are discussed below. While many of these problems arise with respect to other forms of employee remuneration, particularly those that are based on the value of shares of the employer or a related company, they are particularly acute in the case of stock-options. This is largely due to the fact that stock-options are often taxed at a time (e.g. when the option is exercised or the shares sold) that is different from the time when the employment services that are remunerated through these options are rendered.***

***12.1 As noted in paragraph 2.2, the Article allows the State of source to tax the part of the stock-option benefit that constitutes remuneration derived from employment exercised in that State even if the tax is levied at a later time when the employee is no longer employed in that State.***

***12.2 While the Article applies to the employment benefit derived from a stock-option granted to an employee regardless of when that benefit is taxed, there is a need to distinguish that employment benefit from the capital gain that may be derived from the alienation of shares acquired upon the exercise of the option. This Article, and not Article 13, will apply to any benefit derived from the option itself until it has been exercised, sold or otherwise alienated (e.g. upon cancellation or acquisition by the employer or issuer). Once the option is exercised or alienated, however, the employment benefit has been realized and any subsequent gain on the acquired shares (i.e. the value of the shares that accrues after exercise) will be derived by the employee in his capacity of investor-shareholder and will be covered by Article 13. 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). Where, however, the option that has been exercised entitles the employee to acquire shares that will not irrevocably vest until the end of a period of required employment, it will be appropriate to apply this Article to the increase in value, if any, until the end of the required period of employment that is subsequent to the exercise of the option.***

***12.3 The fact that the Article does not apply to a benefit derived after the exercise or alienation of the option does not imply in any way that taxation of the employment income under domestic law must occur at the time of that exercise or alienation. As already noted, the Article does not impose any restriction as to when the relevant income may be taxed by the State of source. Thus, the State of source could tax the relevant income at the time the option is granted, at the time the option is exercised (or alienated), at the time the share is sold or at any other time. The State of source, however, may only tax the benefits attributable to the option itself and not what is attributable to the subsequent holding of shares acquired upon the exercise of that option (except in the circumstances described in the last sentence of the preceding paragraph).***

***12.4 Since paragraph 1 must be interpreted to apply to any benefit derived from the option until it has been exercised, sold or otherwise alienated, it does not matter how such benefit, or any part thereof, is characterized for domestic tax purposes. As a result, whilst the Article will be interpreted to allow the State of source to tax the benefits accruing up to the time when the option has been exercised, sold or otherwise alienated, it will be left to that State to decide how to tax such benefits, e.g. as either employment income or capital gain. If the State of source decides, for example, to impose a capital gains tax on the option when the employee ceases to be a resident of that country, that tax will be allowed under the Article. The same will be true in the State of residence. For example, while that State will have sole taxation right on the increase of value of the share obtained after exercise 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.***

***12.5 The benefits resulting from a stock-option granted to an employee will not, as a general rule, fall under either Article 21, which does not apply to income covered by other Articles, or Article 18, which only applies to pension and other similar remuneration, even if the option is exercised after termination of the employment or retirement.***

***12.6 Paragraph 1 allows the State of source to tax salaries, wages and other similar remuneration derived from employment exercised in that State. The determination of whether and to what extent an employee stock-option is derived from employment exercised in a particular State 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 be followed for that purpose.***

***12.7 The first principle is that, 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 the right to exercise 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.***

***12.8 In applying the above principle, however, it is important to distinguish between a period of employment that is required to obtain the right to exercise 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 granted, without any condition of subsequent employment, 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.***

***12.9 It is also important to distinguish between a situation where a period of employment is required as a condition for the acquisition of the right to exercise an option, i.e. the vesting of the option, and a situation where an option that has already vested may be forfeited if it is 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 vested 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. The following examples illustrate this distinction:***

- ***Example 1: On 1 January of year 1, a stock-option is granted to an employee. The acquisition of the option is conditional on the employee continuing to be employed by the same employer until 1 January of year 3. The option, once this condition is met, will be exercisable from 1 January of year 3 until 1 January of year 10 (a so-called "American" option[16]). It is further provided, however, that any option not previously exercised will be lost upon cessation of employment. In that example, the right to exercise that option has been acquired on 1 January of year 3 (i.e. the date of vesting) since no further period of employment is then required for the employee to obtain the right to exercise the option.***

- ***Example 2: On 1 January of year 1, a stock-option is granted to an employee. The option is exercisable on 1 January of year 5 (a so-called "European" option). The option has been granted subject to the condition that it can only be exercised on 1 January of year 5 if employment is not terminated before that date. In that example, the right to exercise that option is not acquired until 1 January of year 5, which is the date of exercise, since employment until that date is required to acquire the right to exercise the option (i.e. for the option to vest).***

***12.10 There are cases where that first principle might not apply. One such case could be where the stock-option is granted without any condition 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 option 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 option relates to these new functions even if the right to exercise the option is acquired before these are performed. There are also cases where an option vested technically but where that option entitles the employee to acquire shares which will not 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.***

***12.11 The second principle is that 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 intended to reward the provision of such services by the recipient for a specific period. 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***

16 Under an "American" stock-option, the right to acquire a share may be exercised during a certain period (typically a number of years) while under a "European" stock-option, that right may only be exercised at a given moment (i.e. on a particular date).

*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.*

*12.12 Where a period of employment is required to obtain the right to exercise 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 stock-option benefit should be considered to relate only to the period of services actually performed when these circumstances have in fact occurred.*

*12.13 Finally, 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 a stock-option 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).*

*12.14 Where, based on the preceding principles, a stock-option is considered to be derived from employment exercised in more than one State, it will be necessary to determine which part of the stock-option benefit is derived from employment exercised in each State for purposes of the application of the Article and of Articles 23A and 23B. In such a case, the employment benefit attributable to the stock-option should be considered to be derived from a particular country in proportion of the number of days during which employment has been exercised in that country to the total number of days during which the employment services from which the stock-option is derived has been exercised. For that purpose, the only days of employment that should be taken into account are those that are relevant for the stock-option plan, e.g. those during which services are rendered to the same employer or to other employers the employment by whom would be taken into account to satisfy a period of employment required to acquire the right to exercise the option.*

*12.15 It is possible for Member countries to depart from the case-by-case application of the above principles (in paragraphs 12.7 to 12.14) by agreeing to a specific approach in a bilateral context. For example, two countries that tax predominantly at exercise of an option may agree, as a general principle, to attribute the income from an option that relates primarily to future services to the services performed by an employee in the two States between date of grant and date of exercise. Thus, in the case of options that do not become exercisable until the employee has performed services for the employer for a specific period of time, two States could agree to an approach that attributes the income from the option to each State based on the number of days worked in each State by the employee for the employer in the period between date of grant and date of exercise. Another example would be for two countries that have similar rules for the tax treatment of employee stock-options to adopt provisions that would give to one of the Contracting States exclusive taxation rights on the employment benefit even if a minor part of the employment services to which the option relates have been rendered in the other State. Of course, Member countries should be careful in adopting such approaches because they may*

***result in double taxation or double non-taxation if part of the employment is exercised in a third State that does not apply a similar approach.”***

***Commentary on Article 16***

6. Replace paragraph 1.1 of the Commentary on Article 16 by the following:

"1.1 Member countries have generally understood the term "fees and other similar payments" to include benefits in kind received by a person in that person's capacity as a member of the board of directors of a company (e.g. ***stock-options***, the use of a residence or automobile, health or life insurance coverage and club memberships)."

7. Add the following paragraph 3.1 to the Commentary on Article 16:

***"3.1 Many of the issues discussed under paragraphs 12 to 12.15 of the Commentary on Article 15 in relation to stock-options granted to employees will also arise in the case of stock-options granted to members of the board of directors of companies. To the extent that stock-options are granted to a resident of a Contracting State in that person's capacity as a member of the board of directors of a company which is a resident of the other State, that other State will have the right to tax the part of the stock-option benefit that constitutes director's fees or a similar payment (see paragraph 1.1. above) even if the tax is levied at a later time when the person is no longer a member of that board. While the Article applies to the benefit derived from a stock-option granted to a member of the board of directors regardless of when that benefit is taxed, there is a need to distinguish that benefit from the capital gain that may be derived from the alienation of shares acquired upon the exercise of the option. This Article, and not Article 13, will apply to any benefit derived from the option itself until it has been exercised, sold or otherwise alienated (e.g. upon cancellation or acquisition by the company or issuer). Once the option is exercised or alienated, however, the benefit taxable under this Article has been realized and any subsequent gain on the acquired shares (i.e. the value of the shares that accrues after exercise) will be derived by the member of the board of directors in his capacity of investor-shareholder and will be covered by Article 13. Indeed, it is at the time of exercise that the option, which is what the director obtained in his capacity as such, disappears and the recipient obtains the status of shareholder (and usually invests money in order to do so)."***

***Commentary on Articles 23A and 23B***

8. Add the following paragraphs 4.1 to 4.3 to the Commentary on Articles 23 A and 23 B:

“***4.1 Article 4, however, only deals with cases of concurrent full liability to tax. The conflict in case a) may therefore not be solved if the same item of income is subject to the full liability to tax of two countries but at different times. The following example illustrates that problem. Assume that a resident of State R1 derives a taxable benefit from an employee stock-option that is granted to that person. State R1 taxes that benefit when the option is granted. The person subsequently becomes a resident of State R2, which taxes the benefit at the time of its subsequent exercise. In that case, the person is taxed by each State at a time when he is a resident of that State and Article 4 does not deal with the issue as there is no concurrent residence in the two States.***

***4.2 The conflict in that situation will be reduced to that of case b) and solved accordingly to the extent that the employment services to which the option relates have been rendered in one of the Contracting States so as to be taxable by that State under Article 15 because it is the***

***State where the relevant employment is exercised. Indeed, in such a case, the State in which the services have been rendered will be the State of source for purposes of elimination of double taxation by the other State. It does not matter that the first State does not levy tax at the same time (see paragraph 32.8). It also does not matter that the other State considers that it levies tax as a State of residence as opposed to a State of source (see the last sentence of paragraph 8).***

***4.3 Where, however, the relevant employment services have not been rendered in either State, the conflict will not be one of source-residence double taxation. The mutual agreement procedure could be used to deal with such a case. One possible basis to solve the case 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, if the relevant services were rendered in a third State before the person became a resident of State R2, it would be logical for the competent authority of State R2 to agree to provide relief (either through the credit or exemption method) for the State R1 tax that has been levied on the part of the employment benefit that relates to services rendered in the third State since, at the time when these services were rendered, the taxpayer was a resident of State R1 and not of State R2 for purposes of the convention between these two States."***

9. Add the following paragraph 32.8 and the preceding heading to the Commentary on Articles 23 A and 23 B:

***"F. Timing Mismatch***

***32.8 The provisions of the Convention that allow the State of source to tax particular items of income or capital do not provide any restriction as to when such tax is to be levied (see, for instance, paragraph 2.2 of the Commentary on Article 15). Since both Articles 23 A and 23 B require that relief be granted where an item of income or capital may be taxed by the State of source in accordance with the provisions of the Convention, it follows that such relief must be provided regardless of when the tax is levied by the State of source. The State of residence must therefore provide relief of double taxation through the credit or exemption method with respect to such item of income or capital even though the State of source taxes it in an earlier or later year. Some States, however, do not follow the wording of Article 23A or 23B in their bilateral conventions and 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 (the mutual agreement procedure, for example) to relieve the double taxation which might otherwise arise in cases where the State of source levies tax in a different taxation year."***