Double Dipping: The Cross-Border Taxation of Stock Options

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I. INTRODUCTION

Once awarded exclusively to upper management, stock options are now granted increasingly to rank-and-file employees and are becoming a greater component of employee compensation. The expanding use of stock options is undoubtedly due in part to the large increase in equity prices over the last twenty years. Further fueling the demand was the Internet start-up boom of the late 1990s, the spectacular financial success of many technology and computer companies – notably Microsoft and Oracle, and the well-publicized lucre acquired by their employees. The collapse of the initial public offerings market for Internet start-up companies at the dawn of the twenty-first century, accompanied by the rapid decline in the stock prices of many companies in technology-related sectors, served to apprise employees that option returns are risky. Microsoft’s recent announcement that it plans to replace its option program with a restricted stock program will undoubtedly cause many companies to reevaluate their use of compensatory options. Nevertheless, it appears that options will continue to be an important part of employee compensation.


5. A recent study revealed that the split-adjusted number of option grants increased from 5.9 billion in tax year 1997 to 7.9 billion in tax year 2001, reaching a peak of 8.1 billion in 2000. See SCOTT JAQUETTE ET AL., RECENT TRENDS IN STOCK OPTIONS (U.S. Treasury, Office of Tax Analysis, Working Paper No. 89, 2003), available at http://www.ustreas.gov/offices/tax-policy/library/ota89.pdf (Mar. 2003). The dollar amounts increased over the same period from $116.6 billion to $244.7 billion, peaking in 2000 at $318.1 billion. Id.; see also
Stock options potentially serve two roles. They are intended to motivate employees to work harder by tying their future fortunes tangibly and directly to that of the company; if the company prospers, so will the employees.\(^6\) Options may help to reduce agency costs by better aligning the interests of shareholders and employees. For a start-up company, options can be used to attract talented employees while conserving cash when the company’s products are being developed and revenue is minimal or nonexistent.\(^7\)

U.S. compensatory stock options fall into two categories: (1) qualified, also called incentive stock options (ISOs) or statutory options, and (2) non-qualified options (NQOs), with NQOs being the more common.\(^8\) Compensatory options have a long history in the United States, and the taxation of U.S. options holders and issuers is relatively well established.\(^9\)


Options expose employees to different risks than if they held the underlying stock and thus require greater economic sophistication to manage. See ALAN B. UNGAR & MARK T. SAKANASHI, YOUR EMPLOYEE STOCK OPTIONS (2001). For example, changes in volatility, interest rates, and dividend rates directly affect an option’s value but may not affect the value of the underlying stock. If employees are overconfident and tend to see only the upside potential of options, they may hold an undiversified portfolio, which in the event of an economic downturn, coupled with the fact that options are economically equivalent to levered positions in the underlying stock, could greatly magnify their losses. Albert B. Crenshaw, *All the Nest Eggs in One Basket; Enron Shows What Can Happen to Undiversified 401(k) Plans*, WASH. POST, Dec. 23, 2001, at H2; Christine Dugas, *Retirement Crisis Looms as Many Come Up Short*, U.S.A. TODAY, July 19, 2002, at 1A; Beth Healy, *Esop’s Fable United Airlines’ Crisis Marks The Latest Case Of How Workers’ Stakes Fall With Firms’ Fortunes*, BOSTON GLOBE, Dec. 8, 2002, at G1; Richard A. Oppel, Jr., *Employees’ Retirement Plan Is a Victim as Enron Tumbles*, N.Y. TIMES, Nov. 22, 2001, at A1.

6. Stock options are one of many varieties of equity-linked compensation programs. Others include stock appreciation rights (SARs), phantom stock, and restricted stock. The common feature of these plans is to tie future compensation to the objective financial performance of the company. See Ruth Wimer, *Best New Developments in Stock Options and Deferred Compensation*, 40 TAX MGMT. MEMORANDUM 415 (1999).


8. It has been estimated that 89% of all stock options are NQOs. JAQUETTE ET AL., supra note 5, at 5 n.6.

9. Although section 83, which governs the taxation of NQOs, was enacted in 1969, Pub. L. 91-172, § 321(a), the general rule that nonqualified compensatory options are not taxed until exercised has appeared in treasury regulation section 1.421-6 since 1961. Taxing
As cross-border investment has increased, and human and financial capital have become more mobile, it has become more common for multinationals based in the United States to establish global stock option plans for all employees. To compete for talented employees, foreign-based multinationals also have begun to offer options to their domestic and foreign-based employees.

The tax treatment of options in the cross-border context raises many challenging positive legal and normative questions. These uncertainties arise not only from the application of U.S. law to a particular issuer or holder, but from the interaction of U.S. and foreign laws to option grantors and recipients. The tax policies adopted run the gamut from taxation upon grant, lapse of vesting and transferability restrictions, exercise, or the ultimate sale of the underlying stock. Within a given country, there may also be different tax regimes applicable to different types of options, or employees may elect to be taxed at different times. Finally, because options represent an interest with respect to stock, which is generally a capital asset, some portion of option income may be treated as capital. Thus, when comparing the tax treatment of option income of different countries, there can arise differences of both timing and character.

For the peripatetic employee, the differing domestic taxation of compensatory options can possibly result in double (or multiple) taxation of the same economic income. The differing domestic tax laws also raise the specter for fiscal authorities that option income may not be taxed in any country. Although income tax treaties are intended to foster the international

compensatory options at the time they are exercised, rather than when they are granted or vest, reflects a long-standing Treasury practice. See T.D. 3435, II-1 C.B. 50 (1923).

10. MERCER HUMAN RES. CONSULTING, supra note 1, at 1 (6.3% of large U.S. companies have or plan to make worldwide grants in 2001, up from 4.6% in 1997); see, e.g., P&G Plans To Offer Its Stock Options To Nearly All Workers, WALL ST. J., Nov. 7, 1997, at B9.

11. Andrew Osterland, Down Market, Big Upside, CFO MAG., Feb. 1, 2002, at 68 (noting that multinationals are "ramping up" their employee stock option plans to attract and retain employees, despite the downturn in the world markets); Tom Buerkle, Europe Catches American Fever For Incentives Based on Market, INT’L HERALD TRIB., Apr. 5, 2000, at 11.


13. In the United States, for example, if an employee was granted an option that had a readily ascertainable fair market value, but was subject to substantial risk of forfeiture, an employee could elect to be taxed currently under section 83(b).

14. In the United States, for example, gain realized from the sale of stock received upon exercise of ISOs is capital.
movement of capital and persons by mitigating double taxation, in many situations, the differing domestic tax treatment of compensatory stock options will lead to irreconcilable interpretations of treaty provisions and possible double taxation or exemption. Without the adoption of new international norms for compensatory option income, these concerns are very real and may unnecessarily discourage the adoption of global stock option plans, impede the cross-border movement of employees, and potentially skew employee migration from countries with unfavorable stock option tax rules to countries with more favorable stock option tax rules.

The only U.S. tax treaty that specifically addresses the treatment of stock options is the U.S.-U.K. Treaty, which entered into force on March 31, 2003. The guidance in the Treaty is limited, and it is unclear whether the Treaty provisions should be extended to different types of stock options and equity-linked compensation plans. Furthermore, it is not clear whether the approach in the U.K. Treaty can be extended to countries with dissimilar approaches to taxing stock options. The commentary to the OECD and U.S. Model Income Tax Treaties are silent on the issue. Recognizing the importance of the issue, a subgroup of the OECD Committee on Fiscal Affairs has recently issued a revised public discussion draft that addresses certain issues raised by stocks options in the cross-border context.

If the current discussions lead to an international consensus on the proper taxation of stock options, countries whose domestic tax rules diverge from this approach may find it necessary to revise their law. Furthermore, the international tax issues raised by compensatory stock options are analogous to issues raised by other types of deferred compensation.


arrangements, including restricted stock and pension plans. The approach adopted by the international community for options may thus have ramifications for other areas that, as the cross-border movement of persons becomes more common, must be faced. The unique U.S. policy of taxing its citizens and resident aliens wherever resident on their worldwide income, however, complicates the task of crafting a common international approach to mitigate double taxation.

This Article examines the international tax issues raised by global stock option plans. It first examines the financial reasons for and unique issues raised by granting employees stock options and the U.S. accounting treatment of stock option plans. It then reviews the U.S. and tax treaty rules applicable to holders and issuers of non-qualified stock options and examines the conflicts that arise when a compensatory option holder or option income is subject to the tax jurisdiction of more than one country. Finally, it considers unilateral, bilateral, and multilateral policy options of tax administrators in the face of the global stock option plans. This Article argues that the United States should consider unilaterally amending its foreign tax credit regime to prevent the double taxation of option holders, incorporate option provisions in its income tax treaties, and support the general multilateral approach set forth in the OECD Report.

II. THE THEORY AND PRACTICE OF COMPENSATORY STOCK OPTIONS

A call option is a bilateral contract that entitles the holder to purchase property in the future from the grantor/writer at a price fixed today – the exercise or strike price. In exchange for the right to purchase, the holder must generally pay a premium to the option writer. A call holder benefits when the price of the underlying property rises above the exercise price, because the property can be purchased for less than its fair market value. Since a call option holder possesses the right but not the obligation to buy,

21. Id.
22. Id.
his potential loss is limited to the premium paid. Employees generally do not pay a premium for their options, but the options are usually subject to vesting and transferability restrictions.²³

To better align the incentives of the shareholders and employees (including management), and thereby potentially reduce agency costs, companies grant call options²⁴ to employees. If the employees' efforts increase the value of the company and share price, the shareholders share some of the increased value with the employees who created it. If the employees' efforts fail to increase the value of the company, the options will expire without having been exercised. Options help ensure that poor performance is not rewarded, and the benefits of good performance are shared.²⁵

Some commentators have argued that a compensatory option grant linked solely to the price of the company's stock may not be optimal for shareholders or employees.²⁶ A stock option granted at a fixed strike price rewards the holder when the stock price increases, even though the increase may merely reflect an overall bull market. Conversely, price decreases due to a bear market penalize an option holder even though the company's performance relative to its peers may be exemplary.

Because options are contracts and their terms potentially quite flexible, they could be drafted to tie payoffs to very specific economic events instead of simply to the movement of the company's stock price. For instance, an

²³ Brian J. Hall, What You Need to Know About Stock Options, 78 HARV. BUS. REV. 122 (2000).
²⁴ In contrast to exchange traded options, options issued by a company are technically referred to as warrants. The exercise of a warrant increases the number of shares outstanding, which affects the valuation of a warrant vis-à-vis an exchange traded option on the same stock. See BREALEY & MYERS, supra note 20, at 647-49. Following standard practice, this Article will refer to employee warrants as options.
²⁵ Options may be more appropriate for upper level management whose decisions may actually influence future company performance. For rank and file employees, however, the ability of options to motivate is not as clear. Not all investors believe that options provide the proper incentive. One of the most successful investors ever, Warren Buffet, CEO of Berkshire Hathaway, does not offer options to Berkshire's managers. Danielle Herubin, Stock Options The Rage, But Who Benefits?, PALM BEACH POST, June 15, 1998, at 18 (noting that when Warren Buffet's investment company, Berkshire Hathaway, buys a company, it immediately terminates the stock option plan and increases the cash portion of the compensation plan). Options and other equity-linked compensation may be tax inefficient, as compared to cash. See Calvin H. Johnson, Stock Compensation: The Most Expensive Way to Pay Future Cash, 52 SMU L. REV. 423, 440-45 (1999).
option could be designed with an exercise price that is tied to the relative performance of the company vis-à-vis the market or an index of its competitors. These more narrowly tailored options may better serve to align incentives of employees and shareholders. In spite of the potential benefits of such tailored options, option terms are relatively standard, perhaps due primarily to the unfavorable accounting treatment accorded options whose terms are not fixed at grant. For CEOs of large, public companies, one study found that most options were overwhelmingly granted with exercise prices equal to the stock price on the date of grant and had a term of ten years.

Although options may help to reduce agency costs by linking pay and performance, because an option holder owns an option rather than the underlying stock, options may exacerbate other owner-manager conflicts. In particular, because an option’s value increases when the volatility of the underlying stock increases, managers who hold a significant portion of their wealth in the form of options, especially out-of-the-money options, may have an incentive to undertake riskier projects and thereby increase the likelihood of extreme gains and losses for the firm. A holder of a stock option benefits from increased volatility differently than a holder of stock. Although increased volatility means there is a greater chance of larger gains and losses, an option holder benefits from the larger gains but does not suffer in the event of losses. This may induce executives to "bet the


28. For a discussion of why indexed options are not used more often, see Saul Levmore, Puzzling Stock Options and Compensation Norms, 149 U. PA. L. REV. 1901, 1910 (2001) (stating that parties shy away from indexed options because "they must report greater expenses and then show smaller profits than they do if they deploy conventional fixed options"); see also David M. Schizer, Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility, 100 COLUM. L. REV. 440, 501-02 (2000); David M. Schizer, Tax Constraints on Indexed Options, 149 U. PA. L. REV. 1941, 1941 (2001) (arguing that tax too may play a role in the lack of indexed options observed in the market).


30. Hall & Murphy, Stock Options, supra note 2, at 20.

31. See id.; Richard A. DeFusco et al., The Effect of Executive Stock Option Plans on Stockholders and Bondholders, 45 J. FIN. 617, 618 (1990). Also, since an option holder does
house" on risky projects that offer very remote chances of high payoffs, but that should not otherwise be undertaken.32

Employee stock options also raise difficult issues of valuation for both the company granting them and the employee receiving them. It is important for the company granting options to understand how to value them and why the cost to the company and the employee may diverge. Companies then can determine the cost of options and compare it to alternative compensation plans, including what the company could receive for selling in the market similar non-compensatory options. Standard option valuation models, such as the Black-Scholes model, cannot be used without making significant adjustments to take into account the nonstandard features of many employee stock options, such as long maturity, delayed vesting, forfeiture, and non-transferability.33 Even though option pricing models can be somewhat adjusted to account for these differences, the valuations arrived at can be much more subjective than those of exchange traded options.34 For instance, the term of employee stock options – typically ten years and much longer than normal exchange traded options – makes the option valuation more sensitive to mistakes in estimating volatility, interest rates, and dividends on the underlying stock.35

not usually benefit from dividends paid with respect to the stock prior to exercise, there is an incentive to avoid dividend payments, which may harm shareholders. Murphy, supra note 29, at 18.

32. Some researchers, however, have found that options might induce managers to reduce risk. See, e.g., Jennifer N. Carpenter, Does Option Compensation Increase Managerial Risk Appetite?, 55 J. Fin. 2311, 2325 (2000).


34. For options issued by private companies, the Black-Scholes model, which incorporates certain assumptions regarding the liquidity and price movement of the underlying stock, is particularly problematic.

35. See Rubinstein, supra note 33; Murphy, supra note 29, at 19. Even the most sophisticated companies face difficulties. See Jonathan Weil & Betsy McKay, Coke Developed a New Way to Value Options, But Company Will Return to Its Classic Formula, WALL ST. J., Mar. 7, 2003, at C3 (detailing Coca-Cola's abandonment of its plan to value employee stock options by reference to quotations from independent financial companies and instead use Black-Scholes).
One issue that has recently attracted more attention of researchers is the valuation placed on the option by the employee, which almost certainly varies from the valuation arrived at by the company.36 Because employees cannot easily hedge, are generally risk averse, may own an undiversified investment portfolio because of human and financial capital tied up in the company, and may leave or be fired before the options vest, employees will generally discount the value of options given by the company (or similarly require a large premium to accept options rather than cash). One study has found that the value to an employee of an option depends inversely on risk-aversion, positively on outside wealth, and inversely to stockholdings.37 This fact has important implications for companies designing optimal compensation programs and tailoring the relevant option parameters such as exercise price.38

With the decline in stock market prices over the last three years, many options are significantly underwater – their exercise price greatly exceeds the underlying stock price – making it unlikely that the options will ever be exercised.39 Many companies, believing that the incentive value of the options is no longer present when the options are so far out of the money, have elected to “reprice” the previously issued options. Repricing smacks some as “heads employees win, tails shareholders lose,” and has been criticized in the financial popular press.40 Firms reprice their options in generally one of two ways: (1) they cancel the existing options and issue new options at a lower strike price, or (2) they lower the strike price of the existing options.41 In contrast to the generally negative view of repricing in

37. Brian J. Hall & Kevin J. Murphy, Optimal Exercise Prices for Executive Stock Options, 90 AM. ECON. REV. 209, 210-11 (2000) [hereinafter Hall & Murphy, Exercise Prices]; Murphy, supra note 29, at 19-20.
38. See Hall & Murphy, Exercise Prices, supra note 37, at 209-10.
40. Gretchen Morgenson, Dispelling The Myth That Options Help Shareholders, N.Y. TIMES, July 29, 2001, at C1 (discussing academic studies concluding that companies that reprice show higher executive turnover and no improvement in financial performance).
41. Under a recent interpretation by the Financial Accounting Standards Board, a company may have to take a charge against earnings for the cost of repricing. FREDERIC W.
III. THE ACCOUNTING TREATMENT OF COMPENSATORY STOCK OPTIONS

Perhaps no other regulatory aspect of compensatory options has received as much scrutiny recently as their financial accounting treatment. Pursuant to the most current guidance issued by the Financial Accounting Standards Board (FASB), companies issuing nonvariable compensatory stock options must account for the options under one of two accounting regimes, Accounting Principles Board (APB) 25 or FASB 123. Under APB 25, a

Cook & Co., Inc., Accounting For Certain Transactions Involving Stock Compensation: An Interpretation of APB Opinion No. 25 (2002), available at http://www.fwcook.com/alert_letters/8-2-02Revised05-01-00FASBInterpretationNo44.pdf (Aug. 2, 2002). A company must take a charge against earnings for repricing based on the difference between the old exercise price and new exercise price. This amount is spread out over the life of the option. Cancellations and reissues are treated as a repricing if done within six months of each other. This has lead many companies to adopt "6+1" repricings: if the old options are cancelled and new options are issued in six months and one day, the cancellation and issuance are not treated as a repricing requiring a charge to earnings. See Liu Zheng, Six-Month-One-Day Stock Option Repricing: An Examination of Accounting Considerations and Incentive Implications (Jan. 2003), available at http://www.fbe.hku.hk/doc/seminars/multimedia/seminar.20030321.pdf.

42. Barabara M. Grein et al., The Stock Price Reactions to the Repricing of Employee Stock Options (Apr. 8, 2003), available at http://ssrn.com/abstract=395400. When options are significantly out of the money, managers holding options may be more inclined to undertake risky projects. See Carpenter, supra note 32, at 2327-28. Repricing may thus be beneficial to shareholders to the extent it ameliorates excessive risk taking. But see Don M. Chance et al., The 'Repricing' of Executive Stock Options, 57 J. Fin. Econ. 129 (2000).

43. This issue has also begun to receive the attention of Accounting Standards Boards outside of the United States. For example, the International Accounting Standards Committee issued its G4+1 Position Paper, Accounting For Share-Based Payment, in which it reviewed the measure and recognition requirements that should govern share-based compensation plans, including employee stock options. Press Release, International Accounting Standards Committee, IASC Publishes G4+1 Position Paper on Accounting For Share-based Payment (July 2000), available at http://www.iasplus.com/pressrel/prg4shar.pdf. The most recent exposure draft, ED 2 Share-Based Payment, issued in November of 2002 and last revised September 30, 2003, is available at http://www.iasc.org.uk/docs/projects/sbp-ps.pdf (last visited Oct. 14, 2003).

44. If the option is considered to be variable because the number of shares to be received or the purchase price is subject to some contingency, different rules apply. Under APB 25, the company records a compensation charge based on the spread at the time of vesting. Under FASB 123, however, the compensation charge is taken at grant. For further details, see Jack S. Levin, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND
company that issues compensatory options at or out of the money does not record any current compensation expense at grant. If the options are exercised, the transaction is treated as a sale of stock for its exercise price, and no compensation expense is recorded at that time or even upon a later sale of the underlying stock. If the options are issued in the money, however, the “intrinsic value” or spread – the difference between the exercise price and fair value of the stock – is treated as a compensation expense, which reduces accounting net income.\textsuperscript{46} This expense is accrued over the service or vesting period.

Under FASB 123, in contrast, the issuing company must take a compensation charge for the “fair value” of the option over the service period using an option pricing model, such as Black-Scholes or a binomial model, that takes into account variables such as the exercise price, stock price, term of the option, the stock’s volatility, and risk-free interest rate to determine the fair value of the options.\textsuperscript{47} In addition, companies that continue to follow APB 25 must disclose in a footnote the accounting net income and earnings per share as if the fair value method of FASB 123 had been adopted.\textsuperscript{48} Although the FASB initially proposed to require companies to use the fair value method for compensatory stock options, the affected companies were able, through intense lobbying efforts, to have the final FASB guidance merely encourage, rather than require, use of the fair value method.\textsuperscript{49} The companies argued that the option valuation methodology for

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\textit{Entrepreneurial Transactions} ¶ 122 (2003).
\end{flushright}

\textsuperscript{45} Accounting For Stock Issued To Employees, Opinions of the Accounting Principles Board No. 25 (1972).

\textsuperscript{46} “Intrinsic value” designates the excess of the stock price over the exercise price; “time value” is the value of the option over its intrinsic value. An option’s value is the sum of both. Before the more modern understanding of option pricing theory, some mistakenly thought that an option without any intrinsic value had no value. The accounting treatment of options may owe its genesis to this misconception. Surprisingly, even today, some U.S. judges still cling to this outmoded analysis. See, e.g., Custom Chrome, Inc. v. Commissioner, 76 T.C.M. (CCH) 386, 393-394, aff’d in part and rev’d in part, 217 F.3d 1117 (9th Cir. 2000) (holding that warrants had no value because, inter alia, they were issued “at the money”).


\textsuperscript{48} Using these pro forma disclosures, analysts have prepared studies that show the extent to which options may dilute current shareholders’ interest in the corporation and affect other accounting measures such as earnings per share and operating margins. \textit{Id.} at 1.

compensatory options was imprecise and would compromise the accuracy of resulting financial statements.\textsuperscript{50}

Because treating options as a compensation cost would reduce reported earnings, prior to 2002, virtually no company did so. Recent corporate scandals involving companies such as Enron and WorldCom have increased focus on the accuracy of financial statements,\textsuperscript{51} and many companies have voluntarily begun to expense options on their financial statements.\textsuperscript{52} The FASB has voted to reopen the issue whether to make such expensing mandatory.\textsuperscript{53} Because companies that do not treat options as an expense are required to make significant disclosures regarding the balance sheet effects if the fair value method has been used, it is unlikely that showing options as an expense will have any discernible effect on stock prices.\textsuperscript{54} But requiring

\textsuperscript{50} Id. Although the concern of the affected companies with the welfare of the general investing public was laudable, it is likely that mandatory adoption of fair value option treatment would result in lower earnings. Id. These companies may have believed that lower "reported" earnings would also lower their stock price. This, of course, would require a belief that the market price of the stock did not already incorporate this information, i.e., that the market did not exhibit semi-strong market efficiency. Since many of the companies that most vociferously complained about fair value treatment are large, publicly traded companies, this fear may be inaccurate, especially given the supplementary disclosure that Statement No. 123 requires. To the extent that managers' compensation, especially bonuses, is based on reported earnings, however, they may be more concerned with their wealth rather than that of the shareholders.

\textsuperscript{51} Many commentators in the popular press opined that the true cost of options was being hidden and investors were being misled. See Zvi Bodie et al., For the Last Time: Stock Options Are an Expense, 81 HARV. BUS. REV. 62 (Mar. 2003); David S. Broder, An Option to Have it Both Ways, PLAIN DEALER (CLEVELAND), Apr. 21, 2002, at 3 (noting the inflated earnings of corporations that did not expense options); Congressional Cowardice, N.Y. TIMES, July 18, 2002, at A20 (calling on Congress to help speed the changeover to counting stock options as an expense); Jane Fuller, Keeping a Grip on Reality, FIN. TIMES (LONDON), Sept. 9, 2002, at 6 (stating that misleading accounting practices, including not expensing options, creates an impression that companies are more profitable than they really are); Robert E. Rubin, To Regain Confidence, WASH. POST, July 21, 2002, at B7 (arguing that expensing of stock options is worth serious consideration to increase confidence among investors).


\textsuperscript{54} See William A. Sahlman, Expensing Options Solves Nothing, 80 HARV. BUS. REV.
options to be expensed may better align the perceived costs and true economic costs of options, and eliminate the disparity among the different types of equity-linked compensation, which would allow companies to experiment with diverse compensation packages that enhance shareholder value.  

IV. U.S. TAXATION OF CURRENT AND NON-QUALIFIED DEFERRED COMPENSATION

This section briefly describes the U.S. tax rules governing current and deferred compensation of U.S. and foreign persons and qualified or incentive stock options and non-qualified stock options. It also describes how deferred compensation is treated under income tax treaties.

A. Current and Deferred Compensation of U.S. and Foreign Persons

The United States taxes the worldwide compensation of its citizens and resident aliens at graduated rates when the income is received, whether it is attributable to services rendered in the United States ("U.S. source") or services rendered abroad ("foreign source"). This is referred to as residence basis taxation. As discussed below, deferred compensation is


55. Hall & Murphy, supra note 2, at 34-35.

56. This Article addresses nonqualified, funded deferred compensation plans. Qualified plans, such as 401(k) plans, are governed by the rules set out in sections 401 - 418E, and are outside the scope of this Article. Non-qualified deferred compensation plans are governed by section 83, which generally treats the transfer of property to an employee by an employer as taxable, except if the property is unvested.

57. For cash basis taxpayers, compensation is included in income in the year it is actually or constructively received. I.R.C. § 451 (West Supp. 2003).

58. §§ 61, 861(a)(4), 862(a)(4) (compensation for services rendered in the United States are "U.S. source" and "foreign source" if rendered abroad). The nationality of the payer/employer and situs of the payment are irrelevant. Id. Sourcing personal service income by reference to the location of where the services were rendered is an international norm. See OECD Model Treaty, supra note 15, at art. 14. The delineation of source based solely on where the services have been rendered has been criticized as being economically simplistic. Yoseph M. Edrey, Taxation of International Activity: FDAP, ECI, and the Dual Capacity of an Employee as a Taxpayer, 15 VA. TAX REV. 653 (1996).
generally taxable when it vests. For U.S. persons, the bifurcation of compensation between U.S. and foreign sources is relevant only for purposes of the foreign tax credit. If compensation is foreign source, the United States cedes primary tax jurisdiction to the source country by allowing a foreign tax credit, subject to certain limits, for foreign taxes paid on the compensation.59

Nonresident aliens are taxed at graduated rates on the income that is effectively connected income (ECI) with a U.S. trade or business.60 Since performing services as an employee or independent contractor, for even one day, in the United States constitutes being engaged in a U.S. trade or business (ETB) for the year, and services are a material factor in earning the income, the U.S. source compensation of foreign persons is generally taxed as ECI.61 In theory, U.S. source compensation can be taxed at a flat 30% rate, as it constitutes income that is fixed, determinable, annual or periodical (FDAP). Since the enactment of section 864(c)(6) in 1986, however, the

59. The United States has a limited form of territorial tax system applicable to U.S. persons reflected in section 911, under which a U.S. citizen residing abroad can exclude from income up to $80,000 of “foreign source” earned income, as well as housing expenses in excess of a threshold based on the U.S. government pay scale. Territorial taxation generally means that a country will levy taxes only on income arising within the country. JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME 12-13 (2000). The United States generally does not adhere to territorial tax norms as it taxes the worldwide income of its citizens, wherever resident. § 1.

60. § 871(a)(1) (imposing a 30% tax on U.S. source FDAP); § 881(a) (stating the same for corporations); § 864(b) (defining “trade or business”).

61. § 864(b) (the performance of personal services within United States constitutes a trade or business); § 864(c)(2) (treating U.S. source FDAP income, which includes compensation, as ECI if the activities of the business are a material factor in the realization of the income). There is a narrow exception for services rendered on behalf of a foreign person, partnership, or corporation not itself ETB and for services rendered for a foreign office of a U.S. citizen, provided that the nonresident is present for fewer than 91 days and the gross amount of the compensation is less than $3000. § 864(b)(1). This exception is largely identical to that in the source rules. § 861(a)(3). This exception was enacted in 1936, but since the figure has not been adjusted for inflation, it has become truly de minimis.

Determining the number of days a nonresident is present in the United States is straightforward: any day or portion thereof counts as a day of presence. See Rev. Rul. 56-24, 1956-1 C.B. 851. It is not clear whether days in transit, which are excluded for purposes of determining resident alien tax status, would count. See Treas. Reg. § 301.7701(b)-3(d) (as amended in 1997). Determining the “U.S. source” portion of the compensation can be more challenging, especially when there is no explicit allocation between U.S. and foreign source services, which is probably the case when an employee temporarily sojourns to the United States on business.
only compensation income taxed at 30% is the earnings and accretions portion of distributions from U.S. qualified deferred compensation plans.\textsuperscript{62} Prior to 1986, it was possible to limit U.S. tax on U.S. source compensation income earned by foreign persons by deferring and paying the compensation in a year during which the foreign person was not ETB, i.e., a year during which no services were performed in the United States. This prevented the income from being treated as ECI.\textsuperscript{63} Even if the income were U.S. source FDAP (fixed or determinable annual or periodical), some argued that under certain treaties, source country taxation was prohibited and the income thus escaped U.S. taxation.\textsuperscript{64} The enactment in 1986 of section 864(c)(6), which treats as ECI income that would have been ECI had it been received during a year in which the foreign person was ETB, forecloses this possibility. Consequently, compensation attributable to services rendered (or to be rendered) in the United States, but which is received in a year that the recipient is not ETB, is treated as U.S. source ECI. The application of section 864(c)(6) to compensatory stock options is discussed below.

\section*{B. U.S. Taxation of Compensatory Stock Options}

Compensatory stock options, a type of contingent, deferred compensation, are subject to two separate tax regimes. ISO holders are potentially taxed upon the sale of the underlying stock at capital gains rates, whereas holders of NQOs are taxed, at ordinary rates, on any gain when the options are exercised. ISO issuers receive no tax deduction, but NQO issuers receive a compensation deduction when the holder includes the option gain in income. Consequently, incentive stock options are not nearly as popular as non-qualified options.\textsuperscript{65} The disparate domestic tax policies reflected in the treatment of ISOs and NQOs make it more difficult for the United States to articulate a single, international tax policy for taxing compensatory options.

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{62} See Blum, \textit{supra} note 18, at 275-84.
\item \textsuperscript{63} Treas. Reg. \textsuperscript{\textsection} 1.864-3(b) ex.3. The income was not ECI because of the requirement in section 864(c)(1)(B) that a taxpayer be engaged in a trade or business in a given year for income to be effectively connected.
\item \textsuperscript{64} See \textit{infra} note 118.
\item \textsuperscript{65} See \textit{Jaquette et al.}, \textit{supra} note 5, at 5 n.6 (89\% of all stock options are NQOs).
\end{itemize}
\end{footnotesize}
1. Incentive Stock Options

ISOs are options to purchase stock of a corporation granted to an individual in connection with her employment.\(^66\) To qualify as an ISO, the option must satisfy detailed statutory rules pertaining to the grantee's employment status; the minimum holding period between grant, exercise and disposition; shareholder approval of the option plan; the maximum term; the maximum strike price; transferability restrictions; employee stock ownership restrictions; and the maximum amount of the options.\(^67\) If these rules are satisfied, the grantee will not recognize income until the underlying shares are sold. Thus, neither grant, vesting, nor exercise is a taxable event.\(^68\) Furthermore, any gain realized upon sale of the underlying shares may qualify as capital.\(^69\) For ISOs that satisfy these requirements, the grantor corporation does not receive any compensation deduction upon grant, vesting, exercise, or sale of the underlying shares. In essence, although the option is required to be granted solely in the context of an employment relationship, for tax purposes the option grant is treated entirely as a capital transaction in the underlying shares to both the grantor corporation and grantee employee.\(^70\)

The ISO rules are generally more favorable to the grantee than the NQO rules because any subsequent gain is taxed as capital gains rather than ordinary income.\(^71\) ISO holders face one potentially detrimental rule – when the options are exercised, the difference between the strike price and fair market value of the stock is treated as an add-back for purposes of the

\(^{66}\) § 422(b).

\(^{67}\) § 422. If these requirements are not satisfied, the option is taxed pursuant to section 83. For example, to the extent that the fair market value of stock with respect to which ISOs are exercisable for the first time exceeds $100,000, the options will not qualify as ISOs. § 422(d).

\(^{68}\) § 421(a)(1).

\(^{69}\) § 422(a)(1) (to qualify for capital gains treatment, an ISO must be exercised at least two years from grant and one year from exercise).

\(^{70}\) Although ISOs are treated as capital transactions to both the issuer and holder, the IRS believes that since they are granted in the employment context, they should be treated as compensation subject to social security taxes. Proposed regulations were issued that would have subjected ISOs to social security taxes at exercise. Prop. Treas. Reg. § 1.3121(a)-1(k). 66 Fed. Reg. 57023 (Nov. 14, 2001). This position was controversial, and one year later, the IRS issued a moratorium on the assessment of social security taxes on ISOs. I.R.S. Notice 2002-47, 2002-28 I.R.B. 97.

\(^{71}\) For tax year 2003, the highest rate for ordinary income is 35%, whereas the highest rate for capital gains is 15%, except for collectibles gain and other trivial miscellanea. § 1(a), (h).
alternative minimum tax. Thus, exercise could cause the option holder to be subject to the alternative minimum tax, but not the regular income tax.

2. Non-Qualified Options and Section 83

a. Overview

Compensatory options that do not satisfy the detailed requirements applicable to ISOs are eventually governed by section 83 when the options are exercised. Thus, an employee realizes income not when an option is granted or vests, but when it is exercised, provided that the underlying stock received could be transferred immediately. The corporation granting the option is entitled to a matching compensation deduction. The compensation element of the option grant then terminates for both employee and corporation; any subsequent realized gain (loss) on the stock received is taxed as capital gain (loss), and no further deduction is allowed to the corporation.

b. Section 83 in General

Under section 83, when property is transferred in connection with the performance of past, current, or future services, the recipient is taxed on the

72. § 56(b)(3).
73. Some employees of high-tech companies whose stock price precipitously dropped after exercise when the tech bubble burst in 2000 were wiped out. When the stock price dropped, its value was insufficient to cover the AMT liability. See Robert L. Sommers, ISOs Meet the AMT: Employees Ambushed by the Tax Code, 91 Tax Notes 2055-56 (June 18, 2001). Not only were these persons subject to federal AMT, but to state AMT as well. See Allen Prohofsky, Another Bubble Burst: Stock Options and the California AMT (Mar. 24, 2003), available at LEXIS, 2003 STT 56-7.
74. Treas. Reg. § 1.83-6 (amount of deduction is equal to amount included in gross income under section 83(a)).
75. Property does not include “either money or an unfunded and unsecured promise to pay money or property in the future.” Id. § 1.83-3(e) (as amended in 1985). Stock appreciation rights (SARs), which are contractual arrangements whereby employees receive the value of appreciation in the stock over a certain time, are not subject to section 83. Priv. Ltr. Rul. 86-42-025 (July 16, 1986); id. 79-46-072 (Aug. 20, 1979).
For property to be considered “transferred,” “beneficial ownership” must be acquired. Treas. Reg. § 1.83-3(a) (as amended in 1985). There has been no transfer if the property is encumbered by contractual obligations that limit the transferee’s economic risk of loss and opportunity for gain. Id. § 1.83-3(a)(6). Transfers of options to purchase property, or transactions that are deemed equivalent to the transfer of an option such as the transfer of
fair market value of the property on such date if the property is either (1) transferable or (2) vested (or using the language of the statute, is not "subject to a substantial risk of forfeiture"). Property is subject to a substantial risk of forfeiture if, for example, the recipient is required to perform (or refrain from performing) substantial services for the transferor. Property is transferable once it can be transferred freely and without any substantial forfeiture restrictions.

Once property is substantially vested, i.e., it is either transferable or not subject to substantial risk of forfeiture, its fair market value, less any amount paid by the employee, is included in the employee's income. Because such property is transferred in connection with the performance of services, it is taxed as compensation income at ordinary rates. The employer's deduction property in exchange for a nonrecourse debt, do not constitute the transfer of the underlying property. Id. § 1.83-3(a)(2), (a)(4). Where the recipient does not risk the possibility of loss, but only of gain, the recipient's economic position is similar to that of a call holder, and no transfer of property will be deemed to have occurred. See id. § 1.83-3(a)(7) ex.5. In contrast, for many purposes of the Code, the owner of an option to acquire property is treated as the owner of the underlying property. See, e.g., I.R.C. §§ 318, 958, 1297. If there is no transfer of property, the recipient is not subject to current taxation, and, as a corollary, the recipient may not make a section 83(b) election. Treas. Reg. § 1.83-2(a).

76. § 83(a).
77. Id. § 83(c)(1); Treas. Reg. § 1.83-3(c)(1) (as amended in 1985); id. § 1.83-3(c)(4) ex.1 (example one states that stock transferred to an employee on the condition that it be returned to the employer if the employee terminates employment within a specified time period is considered to be subject to a substantial risk of forfeiture); id. § 1.83-3(c)(2) (a requirement that transferred stock be returned if company's earnings do not increase by a specified percentage constitutes substantial risk of forfeiture). Certain actions, such as being discharged for crime or for cause, do not constitute "substantial risk of forfeiture." Id. Noncompete clauses requiring the employee to return the transferred property upon commencing employment with a competitor are presumptively considered to not constitute substantial risk of forfeiture. Id.
78. § 83(c)(2); Treas. Reg. § 1.83-3(d) (as amended in 1985).
79. Lapse restrictions are disregarded in determining the amount included in income. Nonlapse restrictions are restrictions that never lapse. For example, the requirement that the property be sold pursuant to a pre-established formula affects the property's fair market value, but not whether the property is included in income in the first place. § 83(d)(1); Treas. Reg. § 1.83-3(h) (as amended in 1985); id. § 1.83-5 (1978).

If property is received, is subject to a substantial risk of forfeiture, and no section 83(b) election has been made, the recipient is not considered the owner of the property for tax purposes, and any income received with respect to the transferred property is treated as being earned by the property owner and then transferred to the holder as additional compensation. Id. § 1.83-1(a)(1)(ii) (1978). If a section 83(b) election has been made, then the recipient is treated as the owner of the transferred property and the income retains its tax character (e.g., dividends, interest) and is not treated as compensation. See Rev. Rul. 83-22, 1983-1 C.B. 17.
for compensation is symmetrical in amount and timing to the employee’s inclusion.  

The sum of the section 83 inclusion and any amount paid becomes the property’s basis, and the holding period begins on the day after transfer.  

If the property received is both nontransferable and subject to a substantial risk of forfeiture, the recipient may elect under section 83(b) to include the value of the property in income in the year of transfer.  

Although the recipient must include the value of the property in income earlier than is otherwise required under section 83(a), any subsequently realized gain is treated as capital.  

As discussed below, it is rarely tax efficient to make a section 83(b) election.  

c. Section 83 and Compensatory Options  

Section 83 does not apply to transfers of ISOs and stock options without a “readily ascertainable fair market value.”  

Instead, for these options, section 83 potentially applies not upon grant but upon exercise of the option and receipt of the underlying property.  

The exclusion from section 83 for options without a readily ascertainable fair market value codifies the holdings of two Supreme Court cases, Commissioner v. Smith, and Commissioner v. LoBue.  

In Smith, the court ruled that an employee who received at-the-money options, which were found not to have any market value when granted, to purchase the stock of a third corporation, recognized compensation only when the options

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80. § 83(h). This section is not an independent basis on which to deduct compensation to an employee, but is merely a timing rule. Thus, if the compensation is paid in connection with the acquisition of property, and would be subject to capitalization under section 263, no deduction would be allowed. Treas. Reg. § 1.83-6(a)(4) (as amended in 2000).  


82. § 83(b). The value of the property is determined without regard to any restriction, except restrictions that will never lapse. Id. Thus, there is no discount for the lack of transferability or substantial risk of forfeiture, unless those restrictions will never lapse.  

83. If, however, the property was included in income under section 83(b), no deduction is allowed for any realized loss. Id. The regulations permit the deduction for any amount actually paid for property. Treas. Reg. § 1.83-2(a) (1978).  

84. See discussion infra Part IV.B.3.b.  

85. §§ 83(e)(3), (d)(4). Other statutory exclusions apply to qualified deferred compensation granted pursuant to sections 401(a) or 404(a)(2), and group-term life insurance to which section 79 of the Code applies. §§ 83(e)(2), (5).  

86. 324 U.S. 177 (1945).  

were exercised. 88 Similarly in *LoBue*, the Court found, following longstanding Treasury practice, that an employee who had received in-the-money options, some of which were nontransferable and subject to a substantial risk of forfeiture, was not taxable until the options were exercised. 89

Regulations under section 83 adhere to the distinctions sketched out in *Smith* and *LoBue* between options that have a readily ascertainable fair market value and those that do not, but adopt a very narrow definition of readily ascertainable fair market value. In general, an option does not have a readily ascertainable fair market value unless it is “actively traded on an established market.” 90 Because most non-qualified options have an average maturity of ten years, and most exchange traded options have a maximum maturity of nine months, it is extremely unlikely that an option will have a readily ascertainable fair market value. 91 Non-publicly traded options are treated as having an ascertainable fair market value only if their value can be measured with “reasonable accuracy,” which requires that the recipient can demonstrate that: (1) the option is transferable and immediately exercisable; (2) neither the option nor the underlying property is subject to any condition that significantly affects the option’s value; and (3) the option’s value is readily ascertainable under regulations. 92

88. *Smith*, 324 U.S. at 181-82. The Court specifically stated that “in other circumstances not here present the option itself, rather than the proceeds of its exercise, could . . . be found to be the only intended compensation.” *Id.* at 182.


91. There are exceptions. For example, long-term equity anticipation securities (LEAPs) have maturities of up to three years. CHI. BD. OPTIONS EXCH., EQUITY AND INDEX LEAPS, http://www.cboe.com/optProd/understanding_products.asp#//leaps (last visited Jan. 11, 2004).

92. Treas. Reg. § 1.83-7(b)(2)(i)-(iv) (1978). The regulations, promulgated in 1978, give very little guidance on determining the value of the option. The most detailed discussion states some common sense knowledge that the value of an option consists not only of any immediately realizable value (intrinsic value) but also the chance to profit from future increases in the value of the underlying stock (time value). The regulations state that it is necessary to consider whether the value of the underlying property can be ascertained, the probability of increase/decrease in the underlying property, and the term of the option. *Id.* § 1.83-7(b)(3).

When the regulations were drafted, it is not very likely that basic option pricing methodology was known or well understood by the drafters. Since then, however, tax administrators have adopted the basic Black-Scholes methodology. *See, e.g.*, Rev. Proc. 1998-34, 1998-1 C.B. 983 (recognizing that taxpayers can use Black-Scholes to value compensatory options for transfer tax purposes); Rev. Proc. 2002-45, 2002-27 I.R.B. 40, revoked by Rev. Proc. 2003-68, 2003-34 I.R.B. 398; Rev. Proc. 2002-13, 2002-8 I.R.B. 549, revoked by Rev.
By removing options without a readily ascertainable fair market value from the scope of section 83, Congress may have believed it was avoiding difficult valuation questions and perhaps preventing an easy mechanism to turn ordinary income into capital gains through a section 83(b) election when the option was granted.\(^9\) Given the diffusion of knowledge about options and option pricing methodology among tax administrators, however, these concerns may no longer be as relevant.\(^4\) But since the value of nonpublicly traded options varies greatly depending on estimates of unobservable quantities, such as volatility, employee stock options should probably still be governed by the wait-and-see approach.

For options without a readily ascertainable fair market value, section 83 applies when the option is either exercised or disposed of, even though the option may have a readily ascertainable fair market value prior to exercise or disposition.\(^5\) Consequently, when an option is exercised, the value of the stock received less the exercise price is included in income as compensation if it is transferable or not subject to a substantial risk of forfeiture, or a section 83(b) election is made. Income tax is deferred if the property received is not transferable and subject to a substantial risk of forfeiture and no section 83(b) election is made. If section 83 applies at exercise, the compensation component of the option grant terminates for both employee and employer, and any subsequent gain or loss realized upon a sale or disposition of the stock is capital to the employee and no deduction is allowed to the employer.\(^6\)


94. The IRS has issued detailed guidance on applying the Black-Scholes model to transfers of compensatory stock options for transfer tax purposes. Rev. Proc. 1998-34, 1998-1 C.B. 983. The need to value options subject to transfer tax is somewhat different for income tax concerns. When property is subject to transfer tax, it must be valued in order for the transferor to determine her liability. It would not be feasible to wait until the transferee either sold or exercised the option. For income tax purposes, it is possible to wait until there has been some type of market transaction, since the tax will eventually fall on the option holder. The option holder does benefit, however, from deferral to the extent that the option could be valued upon grant or vesting. For a general discussion, see William A Raabe et al., *Using the Black-Scholes Option Model in Tax Valuation, available at LEXIS*, Tax Analysts, Tax Notes Today, Nov. 26, 2002, 2002 TNT 228-27.


96. When options are exercised, the amount included in income plus any amount
If, as expected, the accounting rules change so that compensatory options must be expensed, it could be questioned whether the tax rules should also be modified to require income recognition at grant. In spite of the diffusion of knowledge regarding option pricing, given the many nonstandard features of compensatory options, the lack of a public market, and many important parameters that must be estimated, any valuations will be inherently subjective. Companies may have an incentive to give low valuations to increase net accounting income and allow employees to convert ordinary income into capital gain at a potentially low tax cost. On the other hand, by using a low valuation, a company's future income tax will be higher. Also, if options are taxed at grant, employees may be forced to sell other assets to pay any tax liability. Options would be taxed less favorably than other types of deferred income, thus limiting their attractiveness. Finally, accounting has different goals than the income tax, namely, to provide information useful to investors and creditors, such as future cash flow, a company's resources, and claims on those resources.

Although the income tax aims to measure realized accessions to wealth, and options are accessions to wealth, given the difficulty in determining option values, the incentives parties have to undervalue them, and the tax disadvantage options would suffer vis-à-vis other deferred compensation, the wait-and-see approach should probably be maintained.

3. After-tax Costs and Benefits of Different Compensatory Option Schemes

a. ISOs v. NQOs

Because the employer corporation does not receive a deduction when the grantee realizes income from ISOs, when the tax liabilities of both parties are considered, ISO plans are generally more tax inefficient than NQOs. If the corporate tax rate is 35%, and the individual tax rates for ordinary income and capital gains rate are respectively 35% and 15%, for every $10 of ISO income, the net taxes paid by both the corporation and grantee are roughly $5, or 50%. In contrast, for every $10 of NQO income, the

Originally paid for the option, plus the exercise price become the basis of the stock. The holding period for the property begins on the day of exercise. Id. § 1.83-4(a).

97. See discussion infra Part IV.B.3.b.

government receives no net taxes. An ISO plan may be more valuable than an NQO plan, for instance, when a corporation cannot use the deduction for the option income, as is the case of a start-up company with no taxable income or a company with net operating losses. Also, since taxes are generally paid earlier in NQO plans, ISO plans offer the potential to defer taxes, although in a low interest economy, the value of deferral is reduced.  

b. 83(b) Election v. No 83(b) Election

If a section 83(b) election is made, a taxpayer includes currently in income the value of property transferred even though it is not substantially vested. A section 83(b) election results in a taxpayer paying tax earlier than he would otherwise have to, but with the potential benefit that by closing the compensation component of the transferred property, subsequent gain will be taxed at the capital gains rate. Because of the current disparity between the highest tax rate applicable to ordinary income, 35%, and the highest rate applicable to capital gains, 15%, at first blush it may appear that it could be optimal to pay tax early, provided that the stock is expected to appreciate, because any subsequent gain will be taxed at the substantially lower capital gains rate. Some algebra, however, shows that this approach is generally mistaken.  

In fact, subject to one caveat, and given fixed tax rates, it is always mistaken no matter how great the difference between the rates on ordinary income and capital gains and no matter how great the subsequent rate of appreciation.

Let $V_{int}$ be the initial value of the property transferred that is not substantially vested; $r$ the rate of return on the property; $t$ the length of time the property is held, $T_{cg}$ the capital gains rate; and $T_{oi}$ the tax rate on ordinary income. The after-tax accumulations are as follows:

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99. It can be shown that the NQOs are preferred to ISOs if the corporation's marginal tax rate exceeds the difference between ordinary income and capital gains rate divided by one minus the employee's effective capital gains rate. Myron S. Scholes et al., Taxes and Business Strategy: A Planning Approach 193 (2d ed. 2002).

100. An option holder may not make a section 83(b) election with respect to the option received. Some companies, however, permit option holders to exercise their options prior to vesting and receive unvested stock for which a section 83(b) election can be made. The analysis in this section directly applies to this situation.

(1) Section 83(b) Election Made $\Rightarrow V_{INT}^{*}(1-T_{oi})^{*}((1+r)^{t}-1)^{*}(1-T_{cg})$

(2) Section 83(b) Election Not Made $\Rightarrow V_{INT}^{*}(1+r)^{t}*(1-T_{oi})$

Provided that $T_{cg}$ and $r$ are positive, the third multiplicand will be less than $(1+r)^t$ and the last one will be less than 1, and the product of formula (1) will be less than the product of formula (2), regardless of $T_{oi}$ and $T_{cg}$. This holds even if $T_{cg}$ is greater than $T_{oi}$. This result is somewhat counterintuitive, as one would assume that at some rate of return the benefits of the lower capital gains rate would outweigh the detriment of higher current taxation. In addition, in informal conversations, accountants and other tax advisors have described to the author that making a section 83(b) election is black letter law.102

Since it clear that section 83(b) elections are being made, and assuming that for the most part practitioners are well informed about the above relationship, is there an explanation for this apparent paradox besides the irrationality of advisers and their clients? One scenario under which the section 83(b) election is preferable to deferring income is when the taxes paid today as a result of the 83(b) election would not be available for investment.103 In the formula above, this is the difference between $V_{INT}$ and $V_{INT}^{*}(1-T_{oi})$.

If the cash used to pay taxes could not be invested to earn the same pre-tax return as the property received, then it is possible that by making the section 83(b) election the after-tax return could be higher than if no election were made. This could occur in the case of start-up ventures, non-publicly traded, or closely held companies where the taxpayer could not otherwise purchase the stock received with the money used to pay taxes. Formulas (1) and (2) implicitly assume that the tax paid could be invested to earn the same rate as the property received.104

102. See, e.g., Paul Hastings, Section 83(b) Elections, http://www.xpay.net/rs-83b.htm (last visited Nov. 1, 2003). It is interesting that a popular practitioner treatise discussing section 83 does not analyze when making the section 83(b) election is advisable. JOHN L. UTZ, RESTRICTED PROPERTY – SECTION 83 (2001). Some experienced financial economists have also repeated this conclusion. See SCHOLES ET AL., supra note 99, at 197. All of the practitioners who commented on this Article are aware of the benefits of generally not making a section 83(b) election.


104. To illustrate, assume that a taxpayer with a marginal tax rate of 40% on ordinary
Another circumstance under which making the section 83(b) election is superior to foregoing the election is when the value given to the transferred property for tax purposes is less than its true fair market value. Section 83(b) clearly creates an incentive for taxpayers to understate the value of the property received. The greatest potential for this to occur in closely held, nonpublicly traded companies and start-up ventures.\textsuperscript{105} The Internal Revenue Service is at a great information disadvantage because not only is the property received not publicly traded, and therefore hard to value, but the persons with the greatest incentive to give a low valuation are those with greater knowledge of the potential value and risks of the business.\textsuperscript{106}

Some commentators have argued that the potential to understate the value of the property by making a section 83(b) election may account for the predominant capital structure of start-up ventures.\textsuperscript{107} In start-up ventures funded by venture capital, the outside investors may take a convertible preferred stock interest in the company with the face value of the preferred stock equal to the investment capital.\textsuperscript{108} The entrepreneur(s) and employees may receive non-vested common stock and options.\textsuperscript{109} The respective owners' interests are valued on a liquidation/capital account basis, which due to the contractual provisions of the preferred stock, means that all of the value of the company is allocated to the preferred stock and very little to the common stock received by the founders.\textsuperscript{110} This approach is inconsistent income and 20\% on capital gains receives stock in a nonpublicly traded company, X, that is not substantially vested with a value of $100. The taxpayer has $40 in the bank. If a section 83(b) election is made, the taxpayer pays $40 in taxes and has $100 worth of stock X. If X doubles in value over the next year, taxpayer will have stock worth $200, and if the stock is sold, he would owe $20 in taxes, leaving him with $180. In contrast, if no section 83(b) election were made, taxpayer will have $140 to invest, $100 worth of stock X and $40 in the bank account. If the $40 earns less than the return of stock X, then making the section 83(b) election will be a wise choice. For example, if the cash in the bank earns 10\% and the stock 100\%, then the taxpayer will have $200 in stock X and $44 from the bank account at end of year one. Taxes of $80 (40\% x $200) are owed on the stock investment, and $1.60 on the bank earnings leaving a total after-tax balance of $162.40. Thus, in this illustration, making the section 83(b) election was clearly a better choice, and will always be, provided that money used to pay taxes earns a lower return than the property received.

\textsuperscript{105} See Levin, supra note 44, at \textsection 105, 203.

\textsuperscript{106} It is important to acknowledge that valuation is often more of an art than science and that a range of values could honestly be considered to be a company's fair market value.


\textsuperscript{108} Levin, supra note 44, at \textsection 203.1.

\textsuperscript{109} Id.

\textsuperscript{110} Gilson & Schizer, supra note 107, at 898.
with Internal Revenue Service valuation techniques under section 2031 for estate tax purposes, as it completely ignores the value of the options held by the respective parties and is inconsistent with the internal valuations used by the venture capitalists and entrepreneurs. Perhaps Congress should consider limiting section 83(b) elections to publicly traded assets, the approach used for options.

The above analysis, by focusing solely on the tax consequences to the transferee, is not robust, as it fails to consider the tax consequences to the employer. Under section 83(h), the employer’s deduction for compensation mirrors that of the employee. Thus, where non-vested property is transferred to an employee, the employer’s compensation deduction is deferred until the employee has income. This occurs when: (1) the property is substantially vested, or (2) a section 83(b) election is made, which ever occurs earlier. When a section 83(b) election is made, the employee has income and the employer has a deduction. Any subsequent gain realized when the property is sold is not deductible by the employer. Consequently, in determining whether or not to make a section 83(b) election, the employer’s tax consequences need to be taken into account.

C. Income Tax Treaties and Compensation

Bilateral income tax treaties modify U.S. tax rules for qualified residents of treaty countries. U.S. domestic law divides compensation into two camps: employee and independent contractor compensation. Although both face the same tax burden on their net income, independent contractors can more easily deduct the expenses incurred to earn the income. Income tax

111. It also does not account for any dividend income generated by the restricted stock, and the effect of denied losses if a section 83(b) election is made and a disposition of the property generates a loss.

112. In such situations, it may be advantageous for the employee and employer to modify the contractual arrangement to share any tax benefits and thereby make them both better off. Because the employer does not receive a deduction for any post-83(b) election increase in value, the employer could induce the employee not to make a section 83(b) election by agreeing to compensate the employee for additional taxes paid by not making the 83(b) election. This strategy should be considered when the value of the tax deduction for the compensation payment upon exercise to the employer exceeds the after-tax cost of the payment to the employee.

113. Independent contractors may generally deduct without limitation the ordinary and necessary expenses associated with earning their income under section 162. In contrast, employee business expenses are treated as "below-the-line" miscellaneous itemized deductions and may be taken only to the extent that a taxpayer’s total miscellaneous itemized deductions exceed 2%. I.R.C. § 67 (West Supp. 2003) (subjecting miscellaneous itemized
treaties, in contrast, take a much more nuanced approach than domestic law and distinguish among many types of compensation.114

Treaties divide up primary tax jurisdiction and revenue from compensation income between the source and residence countries based on: (1) the legal capacity of the compensation earner, e.g., independent contractor or employee, and (2) the nature of the services, e.g., director, artist and sportsman, government employee, or student, teacher, and trainees.115 Special rules also apply to certain types of deferred income from pensions depending whether the pension is private or public.116

For independent personal services, such as those rendered by a doctor or lawyer, the residence country has exclusive tax jurisdiction unless the person rendering the independent personal services has a fixed place of business regularly available in the source country. In such a case, the source country has primary tax jurisdiction over the service income attributable to the fixed base.117 The technical explanation to article 14 of the U.S. Model Treaty, which covers independent personal service income, states that the provision is intended to incorporate section 864(c)(6), so that if income that is attributable to a fixed base available to a resident is deferred and received after a fixed base ceases to exist, the source country may still tax it.118

deductions to 2% floor). They may also be subject to the overall limitation on itemized deductions if the taxpayer’s adjusted gross income exceeds certain thresholds. Id. § 68 (mandating an "overall limitation on itemized deductions").

114. Most tax treaties are quite similar, as they are based primarily on the OECD Model Treaty, or for U.S. treaties, on the U.S. Model Treaty. OECD Model Treaty, supra note 15, at ¶ 191; U.S. Model Tax Treaty, Sept. 26, 1996, reprinted in 1 Tax Treaties (CCH) ¶ 214 [hereinafter U.S. Model Treaty]. There is no uniform tax treaty jurisprudence, although even U.S. judges use the commentary to the OECD Model Treaty as interpretive guidance. Part of the reason there is no uniform tax treaty jurisprudence is that treaty terms, if not specifically defined in the treaty, are determined by reference to the domestic law of the treaty's signatories.

115. U.S. Model Treaty, supra note 114, at art. 14 (independent personal services); id. at art. 15 (dependent personal services); id. at art. 16 (directors' fees); id. at art. 17 (artists and sportsmen); id. at art. 18 (pensions, social security, annuities, alimony, and child support); id. at art. 19 (government service employees); id. at art. 20 (students and trainees). The OECD Model Treaty no longer has a separate article covering independent personal services. Instead, such services are taxed under article 7, the business income article.

116. Id. at art. 18.

117. Id. at art. 14, para. 1.

The rationale for limiting source basis taxation in the case of independent services is to treat such service providers similarly to business entities, whose income is taxed in the source country only if their activities rise to the level of a permanent establishment. Since the independent service provider has incurred expenses to generate the income, the source country could not properly tax the income without a determination of the associated expenses. This requires spending resources in the source country to determine the source country tax liability, which is necessary only when the service provider establishes a fixed physical presence in the source country.

Compensation for dependent personal services, i.e., services rendered as an employee, is treated differently. For dependent services, the source country – where the services are performed – has primary tax jurisdiction.119 Residence basis taxation takes precedence, however, when the nexus between the employee, employer, and source country is weak. In particular, source basis taxation is prohibited if: (1) the recipient is present in the source country for fewer than 183 days during any 12 month period that begins or ends during the relevant calendar year; (2) the compensation is paid by an employer that is not a resident of the source state; and (3) the charge for the compensation is not borne by a permanent establishment or fixed base that the employer has in the source state.120 The latter two requirements are intended to prevent compensation from becoming entirely exempt in the source state, which would occur if it were both deducted by the payer and excluded by the recipient.121 Perhaps another way to view this is that if the services do not benefit a business, so that payment for the

section 864(c)(6) is unclear. The legislative history to section 864(c)(6) does not indicate that Congress intended to override existing treaties. Specifically, older treaties limit source basis taxation of dependent services income if the employee is present in the source country for fewer than 183 days in "the taxable year concerned." See, e.g., Convention Between the Government of the United States of America and the Government of Jamaica for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 29, 1981, U.S.-Jamaica, art. 15, 33 U.S.T. 2865, 2885, available at http://www.irs.gov/pub/irs-ty/jamaica.pdf. Many interpreted this provision to refer to the year in which the income was received, rather than when the services were rendered. See Robert T. Cole, Application of Treaty Rules to Income from Services and Licenses, 5 N.Y.U. INT'L INST. TAX & BUS. PLAN., 77, 82-83 (1978). To forestall this argument, the Internal Revenue Service issued a revenue ruling clarifying that with respect to treaties, the "year concerned" referred to the year in which services were rendered and not when payment was received. Rev. Rul. 86-145, 1986-2 C.B. 297. Consequently, in the view of the Internal Revenue Service, there may not be a conflict between older treaties and section 864(c)(6).

120. Id. at art. 15, para. 2.
121. Id.
services generates a deductible business expense, there is not a sufficient
nexus between the source country and the employee to permit source basis
taxation.

The U.S. Technical Explanation to article 15, which addresses the
compensation of employees, states that article 15 is to be interpreted
consistently with section 864(c)(6). Consequently, deferred employee
compensation can be subject to article 15 even though it is received during a
year in which no services were rendered. Its treatment under the treaty is
determined by assuming that it was received in the prior year for which it
was paid.

Treaties typically provide further distinctions between compensation for
dependent and independent services earned in particular capacities, such as
director, artist and sportsman, government employee, or student, teacher, and
business trainee. It is difficult to extract a general tax rule or policy
applicable to these categories of income. Students, teachers, and business
trainees are generally not subject to source basis taxation, whereas artists
and sportsmen are. Perhaps a distinction could be made between income
earned in acquiring or helping others acquire human capital versus income
earned by exploiting human capital.

Persons engaged in these activities would generally not receive options
as part of their compensation. Directors, however, often receive options as
part their remuneration. Director compensation under the U.S. Model
Treaty is subject to tax in the country where the director activities are
rendered. Determining the situs of these services can be difficult in
practice. Directors are generally compensated not only to attend board
meetings, but also to provide a very wide range of advisory services to
corporations. In addition, their compensation includes being paid to devote
time to prepare for meetings. Furthermore, directors of corporations often
wear many hats: they are generally employed full-time elsewhere and
frequently serve on the boards of other corporations. Except for board
meetings, which are held at a particular location and for which compensation

122. Id.
123. See supra note 115 and accompanying text.
124. U.S. Model Treaty, supra note 114, at arts. 17 (artists and sportsmen), 20
(students and trainees).
125. Another factor could be that the income paid to a professional athlete may be a
deductible expense, whereas the income of a student or teacher will not be, since the payer is
most likely a tax-exempt entity.
126. See Murphy, supra note 29, at 6.
127. U.S. Model Treaty, supra note 114, at art. 16.
is often specifically received, it is difficult to assign a source to the other compensation of board members.

The U.S. and OECD Model Treaties approach this issue differently. The U.S. Model Treaty permits source basis taxation of director income.\(^{128}\) In contrast, the OECD Model Treaty permits the country of incorporation to tax the income of a director of a corporation regardless of where the director’s services are performed.\(^{129}\) These conflicting approaches, if reflected in the domestic law of the respective treaty countries, and if applicable to option income, raise difficult issues of international harmonization. Indeed, it is interesting to note that the while the new U.S-U.K. Treaty addresses option taxation, it specifically excludes director option income.\(^{130}\)

V. U.S. TAX RULES, STOCK OPTIONS, AND INTERNATIONAL TAX NORMS

This section examines how persons who receive compensatory stock options and are subject to the tax jurisdiction of more than one country during the life of the options – from grant through sale of the underlying stock received upon exercise – may be subject to international double taxation or exemption with respect to compensatory option income. Double taxation or exemption arises because of disparate domestic tax treatment of option recipients, and in particular, the time at which the compensatory element of the option is taxed.

Some countries tax options when they are granted, some tax options when they vest, others, like the United States, in the case of NQOs, tax options when they are exercised, and still others tax options when the underlying stock is sold, as in the case of ISOs in the United States. In addition, many countries, including the United States, apply different tax rules to different types of options or vary the taxation of compensatory options depending on whether certain elections have been made. Because of these domestic law timing differences, two or more countries can exert residence basis tax jurisdiction over the same income.

Differences in the timing of the taxation of option income could also lead to differences in the character of the income, resulting in disputes over which country has primary, secondary, or any tax jurisdiction over the option income. Once the compensatory element of an option has been taxed, any additional gain from either disposing of the option or the underlying

\(^{128}\) Id.
\(^{129}\) OECD Model Treaty, supra note 15, at art. 16.
\(^{130}\) U.S-U.K. Treaty, supra note 16, at art. 14. The option rule only applies to income of an employee. Director compensation is not covered by article 14, but rather by article 15.
share is generally treated as a capital transaction. If one country were to tax at grant and another tax upon sale of the underlying shares, the first country would classify the excess of the option value at grant over the share price as capital gains; whereas, the second country would treat the entire amount as compensation income. Once differences in timing arise, there will arise perforce differences in character.

This section will analyze the interaction of U.S. and foreign law, including the application of treaty provisions, to option holders in a variety of cross-border settings. The current U.S. domestic regime is insufficient to relieve double taxation in common situations, and there may be policy reasons for providing narrow unilateral relief. The article then examines various bilateral approaches, in particular, the U.S.-U.K. Treaty and proposals put forth by the OECD in its report on employee stock options.

To focus the analysis, assume that an employee is granted a five-year, non-qualified compensatory stock option with a strike price of $50. The option is subject to a three-year vesting period after which time it may be exercised. If the employee ceases to be employed before the end of this period, the option automatically expires. The underlying stock is held after the option is exercised and sold one year later. The option grantee will change tax jurisdiction sometime after grant. The underlying stock increases from $50 at grant, to $80 upon vesting, $90 upon exercise, and $100 upon sale of the underlying stock. The chart below summarizes these assumptions and the cash flows from the transactions.\textsuperscript{131}

\textsuperscript{131} For discussion purposes, this chart assumes that the shares received upon exercise are not immediately sold. Most shares are sold upon exercise either to satisfy tax liabilities, provide cash with which to pay the exercise price, or change risk exposure. See Steven Huddart & Mark Lang, \textit{Employee Stock Option Exercises: An Empirical Analysis}, 21 J. ACCT'G & ECON. 5, 19 (1996).
<table>
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<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
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<td>Exercise</td>
<td>Stock Sale</td>
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<td>20</td>
<td>30</td>
<td>40</td>
<td>50</td>
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<tr>
<td>Black-Scholes Option Value</td>
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<td>29.471</td>
<td>35.70</td>
<td>42.49</td>
<td>50</td>
</tr>
</tbody>
</table>

**Assumptions:**

* Grant at the beginning of Y1
* Vests at the end of Y3
* Stock and option prices are all year end prices, except Y1
* Black-Scholes value using the following inputs: Vol = 30%, r = 5%, T = years, Div = 0%, and Strike = 50
* Y5 option value is expiration value

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**A. Conflicts Arising from Mutual Exertion of Residence Basis Tax Jurisdiction**

**Example 1**

Foreign person (FP), a resident of FC1, receives stock options in year 1 and becomes a U.S. resident in year 2. FP is taxed upon receipt of the options in FC1 as compensation income at 35%, and exercises the options in year 4 while in the United States.

**Example 2**

Same as Example 1, except that the option recipient is a U.S. person (USP).
1. U.S. Tax Rules

Although most countries do not treat the grant of compensatory stock options as a taxable event, some, e.g., Belgium, do.\textsuperscript{132} The rationale behind taxing options at grant is that they are valuable property granted in the context of an employment relationship and therefore should be taxed as compensation income. A country that treats the grant of an option as a taxable event receives taxes, including potentially significant social security taxes, earlier than if taxation were deferred until vesting, exercise, or sale. This tax policy may also reflect perceived egalitarian concerns – since stock options are still generally granted to higher-paid executives, legislators may have believed that deferral of income would be an untoward benefit to confer on executives. Finally, since virtually no countrytaxes its nonresident citizens on a residence basis, but rather on a source or territorial basis, there could be concern that citizens who hold highly appreciated stock options could become nonresidents, exercise their options, and avoid tax completely.

Since the grantee in Examples 1 and 2 is a U.S. person at exercise, the U.S. tax consequences are straightforward: the intrinsic price difference between the exercise price, $50, and the value of the stock received, $90, would be ordinary income under section 83.\textsuperscript{133} The grantee will immediately realize that his overall tax burden is 50.7%: total U.S. and foreign taxes paid of $20.28 (35% x (17.85+40))/total income of $40.\textsuperscript{134} This tax rate is higher than the rate of either country. Both the United States and FC1 have taxed the same amount.\textsuperscript{135} In particular, the United States taxes the $40 difference between the exercise price and stock value, but FC1 also taxes a portion of this amount when the option is granted.

Although these examples focus on double taxation arising when a person receives options in one country where she is taxed on receipt and moves to another country that taxes upon exercise, this conflict arises any time a person moves between countries that have different timing rules for taxing compensatory option income.

\textsuperscript{132} The amount included in income is generally 7.5% of the underlying share value. Any gains realized upon exercise or sale of the underlying shares are not taxable. Belgium Tax Law, art. 42, para. 2; see Marc Quaghebeur, The Modifications to the Belgian Stock Option Regime: Practical Issues, 31 TAX NOTES INT'L 379 (2003).

\textsuperscript{133} This amount would be reduced by any amount paid for the option at grant.

\textsuperscript{134} For FC1 taxation, the Black-Scholes value is used to calculate the income inclusion.

\textsuperscript{135} This result occurs regardless of the respective tax rates of either country and the price movement of the underlying stock.
Example 3
Same facts as Examples 1 and 2, except that FP and USP move in year 2 to FC2, a country that taxes option holders on the Black-Scholes value when options vest at 35%, and reside in FC2 when the options vest.

In this example, there can arise triple taxation: the option holders are taxed in FC1 when the options are granted; in FC2 when the options vest; and in the United States when the options are exercised. Each country in these examples is properly exerting residence basis taxation, but if no country cedes its taxing authority, it is conceivable that the entire option gain could be taxed at rates exceeding 100%. In this example, the total taxes are $32.76 ($6.28 + $12.50 +$14) for a total tax burden of 82%.

Double taxation arising from the serial exercise of residence basis taxation with respect to the same economic income can be mitigated in these examples if: (1) the United States or FC2 accords tax significance to the prior foreign tax event so that the option has a tax basis in the hands of the optionee; (2) the United States or FC2 grants a credit for the earlier foreign taxes paid, either under domestic law or a treaty provision; or (3) FC1 or FC2 refund some or all of the tax to the grantee under a subsequent exercise of residence basis jurisdiction by another country.

a. Prior Foreign Tax Events and Basis

Double taxation could be avoided if the United States were to give effect to the prior foreign tax event. Under long-standing U.S. tax principles, if property is transferred to an employee as compensation and the value of the property is included in income, the property’s basis becomes the amount included in income. By making the basis of the property equal to its value, those dollars will not be taxed again. If, for example, the option had been previously taxed by the United States, the value taxed would be

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137. Basis is conceptually a running total of previously taxed dollars – dollars that have already been included in income. In the case of property transferred to an employee, the transaction could alternatively be viewed as a transfer of cash to the employee equal to the value of the property and deemed a purchase by the employee of the property with the previously taxed dollars.

138. This can perhaps be more clearly seen if the transaction is recast as a transfer of cash followed by an immediate purchase of the property.
added to the basis, which upon exercise (or sale), would lower the realized gain, and thereby eliminate double taxation.\textsuperscript{139} What effect then should be accorded to the prior foreign tax events when neither the property nor the person was subject to U.S. tax jurisdiction?

For property brought into U.S. tax jurisdiction, its U.S. tax attributes, such as basis, are generally determined by treating the property as if it had been subject to U.S. tax jurisdiction ab initio.\textsuperscript{140} This approach raises many policy issues. For the well-advised taxpayer, pre-residency gains can be eliminated by selling the property prior to becoming a resident alien and immediately repurchasing it. For property with built-in losses, such losses can be used to offset future U.S. income by merely waiting to dispose of the property until after becoming a U.S. resident. The tax on gains, at least for assets that are liquid and can be sold for small transaction costs, is thus largely elective.

Treating property as if it had always been subject to U.S. tax jurisdiction also raises considerable administrative burdens for taxpayers who must recreate the U.S. tax record of their assets. In addition, because the U.S. tax record must be computed in U.S. dollars, a taxpayer moving to the United States can be taxed on gains that arise solely because of movements in the foreign currency/U.S. dollar exchange rate between the time of acquisition and sale.\textsuperscript{141} If a person would have a choice with respect to the property, for example, whether to expense or capitalize certain expenditures, or to elect different depreciation methods, how are we to determine which choice the person would have made? If the relevant sections of the Internal Revenue Code were applied literally, since no election was made, the item or property

\begin{itemize}
\item \textsuperscript{139} It would be treated the same as a payment for the option.
\item \textsuperscript{141} See, e.g., Heckett, 8 T.C. at 847 (holding that the basis of property is determined by the exchange rate at the time of purchase); Chief Couns. Adv. 200303021 (Jan. 17, 2003) (advising that a corporation’s basis in a foreign subsidiary’s stock is determined by the dollar exchange rate at the time that the foreign country shareholders acquired their stock in a nonrecognition transaction). The conclusion in the Chief Counsel Advice has been criticized. See Historical, Rather than Current, Exchange Rate Applied in Determining Basis of Stock Acquired by a U.S. Person from Foreign Persons in a B Reorganization, 44 TAX MGMT. MEMORANDUM 148 (2003).
\end{itemize}
should be treated as if no election were made. This approach, however, can produce hardships especially if one considers that the taxpayer would have most certainly elected one treatment or another.\textsuperscript{142}

The issue of property changing tax jurisdiction when the owner changes tax jurisdiction raises many issues and is not comprehensively addressed in the Internal Revenue Code. Although there are comprehensive rules addressing the transfer of assets by a U.S. person to a foreign corporation and to a U.S. person from a foreign corporation,\textsuperscript{143} there are few statutory or regulatory rules addressing changes in property caused by changes in the tax residence of individuals.\textsuperscript{144} For importation and exportation of property that occurs as a result of a person leaving U.S. tax jurisdiction by renouncing his citizenship, Congress considered, but ultimately rejected, a market-to-market approach similar to Canada's.\textsuperscript{145} Instead, Congress opted to change the scope of U.S. tax jurisdiction for some former citizens and long-term resident aliens and continue to subject them to U.S. tax on some transactions that were deemed to have a strong U.S. nexus. Consequently, the tax common law approach, which treats changes in tax jurisdiction as a nonevent, continues to apply in the absence of a contrary statutory mandate, and when property that has been brought into U.S. tax jurisdiction is sold,

\textsuperscript{142} In at least one situation, the United States Congress and the United States Department of Treasury have provided relief for persons changing tax jurisdiction where an election was available but was not made because the person was not subject to U.S. tax jurisdiction. In Technical Advice Memorandum 87-08-002 (Oct. 29, 1986), the Internal Revenue Service ruled that a nonresident alien who had sold property prior to becoming a U.S. resident and received the proceeds after becoming a resident, was deemed to have elected out of the installment method. Thus, there was no U.S. tax liability when the deferred payments were received. The Internal Revenue Service cited the legislative history to amendments to the installment sales provisions, which stated that it was Congress' intent that treasury regulations continue the prior law approach of not subjecting deferred amounts received by a resident that relate to a sale made while a nonresident to U.S. tax. \textit{Id.; see also} Lavoie, \textit{supra} note 140, at 580-85.

\textsuperscript{143} I.R.C. § 367(a) (West Supp. 2003) (relating to transfers of assets out of and into U.S. tax jurisdiction); § 367(b) (relating to transfers of assets among foreign corporations with U.S. owners).

\textsuperscript{144} See, \textit{e.g.}, \textit{id.} § 877(e)(3)(B) (stating that for purposes of expatriation provisions, property of long-term resident alien held upon becoming a U.S. resident has a basis not less than its FMV); \textit{id.} § 1296(l) (stating that the basis of marketable PFIC stock held by person entering U.S. tax jurisdiction is the greater of its FMV or adjusted basis). The last provision eliminates any pre-U.S. residency gains but allows pre-U.S. residency losses to potentially be used.

\textsuperscript{145} For a discussion of these provisions, see Colon, \textit{supra} note 140.
the tax consequences are generally determined as if the property had always been subject to U.S. tax jurisdiction.\footnote{146} Applying the tax common law approach to employee stock options issued in FC1 in year 1 in Examples 1 and 2, it is likely that the employee's basis in the stock option will be zero for U.S. tax purposes, as a stock option grant under U.S. tax rules generally does not produce a current income inclusion.\footnote{147} This would also probably be the result for Example 3 as vesting of stock options too does not trigger taxable income for U.S. tax purposes. Consequently, when the options are exercised, the United States will tax the difference between the exercise price and the stock price pursuant to section 83. Since the options will have no U.S. tax basis, the employee will be taxed twice on the same economic income, once by FC1 at grant and once by the United States upon exercise in Examples 1 and 2, and taxed three times in Example 3. Even if the United States does not accord any significance to the prior foreign tax event, double taxation could be relieved if the United States were to grant a credit for the foreign taxes paid.

b. U.S. Foreign Tax Credit

When income of a U.S. person is taxed by both the United States and a foreign country, e.g., the foreign country taxes on the basis of source and the United States on the basis of residence, the United States unilaterally relieves double taxation through the mechanism of the foreign tax credit. Subject to the limitations of section 904, a U.S. person is permitted a foreign tax credit for all foreign income taxes paid during the year.\footnote{148} Even if the two countries have different timing rules – the source country taxes earlier than the residence country, or vice versa – double taxation can be mitigated if foreign taxes paid in one year can be carried over (or back) to another

\footnote{146. The same issue conceptually arises when property has been owned by a tax-exempt entity and the tax-exempt entity becomes a taxable entity and the proper depreciation (and basis) for the property must be determined. For a discussion of the issue, see Voce, \textit{supra} note 140, at 351-52; \textit{see also} I.R.S. F.S.A. 200133001, 1999 F.S.A. LEXIS 390 (Oct. 27, 1999) (advising that a former tax-exempt entity must adjust the basis of intangible property by the amount of depreciation allowable for that asset since the date of acquisition, even though the taxpayer did not actually claim any deductions for depreciation in the years when petitioner was not subject to tax).

\footnote{147. If the options could satisfy the ascertainable fair market value standard under Treas. Reg. § 1.83-7 (1978), this conclusion would change. Provided that both countries included the same amount in tax basis and sourced the income similarly, double taxation would be avoided.

\footnote{148. § 901(b)(2).}
year. The United States permits excess creditable foreign taxes paid to be carried back two years and forward five.\textsuperscript{149}

For the U.S. person in Example 2, the foreign taxes paid, including social security, would be creditable in the current year depending on the source of the U.S. person's other income.\textsuperscript{150} Any taxes not creditable should be able to be carried forward or back in accordance with section 904(c). The foreign tax credit in this situation mitigates the possibility of double taxation, but does not eliminate it. If the U.S. person could not currently use the foreign tax credit and had to carry it forward, and when the options were exercised the U.S. source of the option income was a significant portion of the total option income, it is very possible that much of the foreign taxes would not be creditable.

\textbf{Example 4}

Same facts as Example 2. Also assume that the option's value for FC1 purposes is $100 and FC1 imposed $35 of taxes in year 1, USP earns an additional $100 of foreign source compensation taxed at 35%, the difference between the exercise price and stock is $100, the U.S. tax rate is 35%, and 75% of the option income is U.S. source.

In Example 4, for year 1, USP would have a foreign tax credit limitation of $35: $100 (foreign source income)/$100 (worldwide income)*$35 (U.S. tax pre-credit).\textsuperscript{151} Since $70 of foreign taxes was paid, $35 could be carried

\textsuperscript{149}. \textit{id.} § 904(c). The Internal Revenue Service has issued detailed regulations to reconcile timing and basis differences between the United States and foreign countries for purposes of the U.S. foreign tax credit separate limitation determination. See Treas. Reg. § 1.904-6. For a thorough and insightful analysis of these regulations, see Benjamin J. Cohen & Jay Geiger, \textit{Timing and Base Differences Under Section 904(d)}, 56 Tax Law. 3 (2002).

\textsuperscript{150}. If the taxpayer elected the provision of section 911 to exclude foreign source earned income, however, she could not take a foreign tax credit with respect to any amount that was properly excluded under section 911. § 911(d)(6).

Once realized for U.S. tax purposes, the option income would fall into the general limitation basket of section 904(d)(1)(l). The foreign taxes would also be allocated to that basket. Treas. Reg. § 1.904-6(a)(1)(iv) (as amended in 1992) (stating that foreign tax imposed on an item of income that is not income under U.S. principles is treated as imposed on general limitation income). The same regulations also provide that taxes on an item of income that would be income in a different year under U.S. principles are allocated to the same basket as if the income were recognized in the United States in the year in which the foreign taxes were imposed. \textit{id.} It is unclear whether the taxation of an option grant by a foreign country would be treated as a basis difference or timing difference. In the case of NQOs it does not matter since, in either case, the taxes would be allocated to the general limitation basket.

\textsuperscript{151}. Under U.S. tax principles, USP would have only $100 of income; the option
back two years and forward five. In year 4, when the option is exercised, USP could only credit $8.75 of the $35 of foreign taxes carried forward: $25 (foreign source income)/$100 (worldwide income)*$35 (U.S. tax pre-credit). The reason double tax arises in this example is that by taxing on an ex-ante basis, the foreign country is in essence treating all of the subsequently realized option income as having a domestic (foreign) country source. The United States, in contrast, taxes option income on an ex-post basis and looks to where the services are rendered between the grant date and exercise date to determine the source of the option income.152

Compared to citizens and resident aliens, however, nonresident aliens are permitted a foreign tax credit on a much narrower base of income, namely, only for foreign taxes paid on foreign source income that is effectively connected with a U.S. trade or business for that year.153 Furthermore, no credit is allowed for foreign taxes that are imposed on U.S. source income solely on the basis of residence. But a credit is potentially allowed for foreign taxes imposed on U.S. source income by a foreign

income would not be taxed by the United States until year 4.

152. In the very rare situation in which the options had an ascertainable fair market value at grant, it would be necessary to determine the source of income. If the options were granted for past services, the source would be determined by looking at where the services were rendered. If granted for future services, the analysis is a bit more complicated. One approach would be to estimate where future services are to be performed. But it is not clear over what period the services would have to be estimated. For signing bonuses given to athletes, the tax court has used estimates of services over the first year of the athlete's contract, rather than over the entire contract term. See Linseman v. Comm'r, 82 T.C. 514, 522 (1984).

153. § 906(a). This provision, enacted as part of the Tax Reform Act of 1966, is intended to provide relief for foreign persons who are subject to U.S. tax on their foreign source ECI. The reason for extending U.S. tax jurisdiction to reach such income was to prevent the United States from being used as a tax haven. See Elizabeth Owens, Foreign Tax Credit Granted to Foreigners, 45 TAXES 463 (1967); Stanford G. Ross, United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments, 22 TAX. L. REV. 279, 328 (1967). Since a foreign person's income can be treated as being effectively connected with a U.S. trade or business even though the person is not actually engaged in a trade or business, if section 906 were applied literally, there would be no relief available. For example, gains from the sale of a U.S. real property interest are treated as ECI. Section 864(c)(6) treats deferred income attributable to a year in which the taxpayer was engaged in a U.S. trade or business as ECI. See § 864(c)(7) (stating that gains realized within ten years of removal of property from a U.S. trade or business are ECI). Most of these provisions were enacted after 1966 and it is doubtful whether Congress ever considered their interaction with section 906. Some commentators have argued for allowing the foreign tax credit under section 906 in those situations. 3 BORIS I. BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION ¶ 72.10, at 72-157, 159 (3d ed. 2003).
country that is not the tax residence of the nonresident alien, or for taxes imposed on U.S. source income by the country of tax residence, provided that the tax would have been imposed regardless of the tax residence of the foreign taxpayer.154

Under the facts of Examples 1 and 3, the interaction of the foreign tax credit rules for nonresidents and the foreign tax credit carryover rules would not likely prevent double taxation. A foreign tax credit can be carried over or back only if the taxpayer has elected to take a credit for foreign taxes paid.155 It is very unlikely that a foreign taxpayer would have elected to take a credit against U.S. taxes for foreign taxes paid when he was a nonresident as he would typically have had no U.S. tax liability in that year. It is not even clear how such an election could be made. Furthermore, since only the amount of the credit that exceeds the foreign tax credit limitation in the year of the election can be carried forward or back, even if the taxpayer were to file an amended return upon moving to the United States and elect the foreign tax credit, there would probably be no amount to carryover because in the year the foreign taxes were paid, there were no excess foreign tax credits under section 906.

It is interesting to consider the tax consequences if either the grant, move to the United States, and exercise occurred in the same year (Example 1) or vesting, move to the United States and exercise occurred in the same year (Example 2). Since the split taxable year does not create two taxable years, but two separate tax regimes for income that falls into each, there would be no issue of carryforward or carryback of foreign taxes.156 If the foreign taxes were paid after becoming a U.S. resident alien, then they should be creditable on the same basis as any other foreign tax paid by a U.S. resident alien.157 It would therefore be necessary to determine the

154. § 906(b)(1)(A).
155. Id. § 904(c).
157. But see Marsman v. Comm'r, 18 T.C. 1, 14 (1952), aff'd in relevant part, 205 F.2d 335 (4th Cir. 1953), aff'd, 216 F.2d 77 (4th Cir. 1954), cert. denied, 348 U.S. 943 (1955) (holding a resident alien that was not entitled to a foreign tax credit for taxes paid by the taxpayer after he became a US. resident where the taxes were attributable to pre-residency income); I.R.S. F.S.A. 200117019, 2001 F.S.A. LEXIS 11 (Apr. 27, 2001). Allowing a credit in such circumstances seems inconsistent with the overall policy of the foreign tax credit, namely, to relieve double taxation. Congress has denied a foreign tax credit for foreign source income excluded from gross income under section 911. § 911(d)(6); cf. id. § 265 (no deduction of expenses incurred to earn tax-exempt income). The continuing vitality of Marsman is questionable, however, given the regulations under section 904(d) and the
source of the option and other income of the U.S. resident to determine how much of the foreign taxes would be creditable.

If the taxes were paid prior to the grantee becoming a resident alien, the foreign tax credit would likely have to be calculated under the rules for nonresident aliens. Since for U.S. tax purposes all of the option income would be taxed by the United States at graduated rates, and none of it would be allocated to the pre-U.S. residency period, even though it accrued during the pre-residency period, the taxes would be creditable only to the extent that the option grantee had either foreign source ECI or U.S. source ECI that was taxed by the foreign country on a basis other than residence. The typical employee would be unlikely to have any such income, since foreign source service income can never be ECI. Even if the employee rendered services in the United States prior to the change in residency, such income would be U.S. source ECI but would probably be taxed by the foreign country on a residence basis.

Double taxation is not relieved in Examples 1 and 3 because some of the income that was taxed earlier in the foreign jurisdiction is now being taxed by the United States and a change of tax jurisdiction causes a change in the basis on which the foreign tax credit is calculated so that the foreign taxes paid in a prior year cannot offset U.S. tax on the subsequently realized income. When a person becomes subject to U.S. tax jurisdiction and income realized after the change in jurisdiction was already subject to foreign tax, consideration should be given to granting some relief. This relief could be unilateral through an adjustment in the U.S. foreign tax credit rules or bilateral through new provisions in income tax treaties.

2. Income Tax Treaty Rules

a. General

Treaties resolve the problem of double taxation primarily in three ways. First, conflicts arising from the mutual exertion of residence basis taxation are resolved by assigning the person only one country of tax residence.

considerable precedent permitting a foreign tax credit for tax-exempt income. See Cohen & Geiger, supra note 149, at 21-28.

158. See discussion infra Part V.B.1.
159. §§ 906(a), (b).
160. § 864(b)(4)(A) (stating that no foreign source income is ECI, subject to certain exceptions); § 864(b)(4)(B) (noting that exceptions include certain rents, royalties, dividends, interest, or income from the sale/exchange of property).
161. If a person is a tax resident of both countries under each country’s domestic law,
Second, various categories of income, e.g., investment income and wages, are assigned a source and jurisdiction to tax is allocated between the source and residence country. Finally, for income properly subject to both residence and source basis taxation, in the relief-from-double-taxation article, treaties provide that the residence country must cede its jurisdiction to tax to the source country by either granting a credit for source basis taxes or exempting source country income. When different countries tax the same income at different periods, and the taxpayer is subject to residence basis taxation for each period, however, treaties do not resolve these conflicts in a way that prevents double taxation.

The application of a treaty to compensatory option income that is taxed on a residence basis by two or more countries is not entirely clear. In particular, with the exception of the new U.S.-U.K. Treaty, no treaty explicitly addresses the situation in which compensation income is properly taxed on residence basis by two countries. What follows are some possible approaches to analyze the issue.

Under one approach, since FP would be a resident alien at the time of exercise, the United States would exert residence basis taxation and tax the option gain as compensation income under section 83. As discussed below, the United States would tax the entire amount of option income, but the income would be allocated between U.S. and foreign sources based on the time worked in the United States and abroad for purposes of determining FP’s foreign tax credit limitation. Since the foreign taxes were paid when the person was a nonresident alien, however, no foreign tax credit would be available against the foreign source income.

If FP was a resident alien under U.S. law, but was still a tax resident of FC1 or FC2, it is possible that under a tie breaker provision FP could be treated as a resident for treaty purposes of FC1 or FC2. In such a case, U.S. jurisdiction to tax the option income would be subject to the provisions of the dependent services article discussed above.

If FP is treated as a resident alien for purposes of both the Internal Revenue Code and any treaty with FC1 or FC2, it is unlikely that a treaty will provide any relief against double taxation. In almost all treaties, pursuant to the “savings” clause of article 1, the United States reserves the right to tax its citizens and residents as if the treaty had not come into effect. This prevents persons subject to U.S. residence basis taxation then the treaty tie breaker provision applies to determine only one tax residence for treaty purposes. See OECD Model Treaty, supra note 15, at art. 4.

162. Id. at art. 23A, 23B.
from using the Treaty to reduce residence basis tax. For example, if a U.S. citizen resides in a country with which the United States has a treaty and receives U.S. source interest, which normally is exempt from source country taxation, the savings clause prevents the citizen from using the treaty to eliminate U.S. tax.164

Since FP would not be invoking the treaty to reduce taxes levied by FC1 or FC2, as the United States is the only country taxing the option income in the year of exercise, the only possible benefit for FP would be under the relief from double taxation article.165 Under this article, the United States must grant a credit for foreign taxes paid, but generally only in accordance with its domestic law. As discussed above,166 foreign taxes paid when the option was granted would likely not be creditable in a subsequent year. The relief from double taxation article generally contains a special provision intended to mitigate double taxation that occurs when the United States and the Treaty counterparty both exert residence basis taxation.167 This provision only applies, however, when the U.S. citizen (or resident alien in some cases) is also a resident of the treaty counterparty and the treaty would reduce or eliminate U.S. tax if the income were received by a resident of the treaty counterparty, who was not a U.S. citizen (or resident alien).168 Thus, since FP would not also be a resident of FC1 or FC2, this provision would not apply.

The conclusions reached above are consistent with the holding of Private Letter Ruling 96-28-024, in which the Internal Revenue Service addressed the taxation of a settlement payment for compensation rendered prior to becoming a resident alien but which was to be received after.169 It may be inferred from the ruling that the resident alien was formerly a resident of a country with which the United States had an income tax treaty. The Internal Revenue Service ruled that the entire settlement payment would be subject to U.S. tax since the recipient was a resident alien in the year of receipt. The Internal Revenue Service also held, without any discussion, that the taxpayer would not be entitled to any treaty benefits, but strangely enough, hedged this conclusion by stating that even if a treaty benefit could be claimed, the savings clause would preserve the United States’ right to tax. The taxpayer also requested a determination of the source of the payment,

164. Id. at art. 11.
165. Id. at art. 23.
166. See supra Part V.A.1.b.
167. See U.S. Model Treaty, supra note 114, at art. 23, para. 3.
168. See U.S. Technical Explanation, supra note 118, at art. 23, para. 3.
but the Internal Revenue Service refused to rule on this issue, since the taxpayer was still rendering services for the corporate group concerned. Apparently, the Internal Revenue Service could not conclude that none of the payment was attributable to services rendered in the United States.

It is interesting to speculate why the taxpayer sought the ruling. If the proceeds were not taxable in the foreign country, then a ruling that the proceeds would not be taxable in the United States would have given the taxpayer the entire amount of the proceeds tax-free. It is highly unlikely, however, that counsel could have believed that the United States would not tax the entire amount of the settlement on a residence basis, even though it was attributable to a year in which the taxpayer was not subject to residence basis taxation.\(^\text{170}\) It is possible that the foreign country was also going to exert tax jurisdiction over the proceeds, perhaps on the grounds that they relate to services performed in the country. This is similar to how the United States would analyze the settlement proceeds.\(^\text{171}\) If the foreign country treated settlement proceeds as domestic source, the U.S. taxes paid would not be creditable. To avoid double taxation, the taxpayer would need to be able to treat the proceeds as foreign source to increase his foreign tax credit limitation. Once the source and character of the payment were determined, the foreign tax credit consequences under U.S domestic law would be straightforward.

It would have been interesting if the Internal Revenue Service had more fully addressed the taxpayer's treaty arguments – if they were worth addressing. A ruling that a treaty would limit U.S. tax would have been beneficial as long the U.S. tax rate was greater than the foreign tax rate. One possible argument would be that the income should be treated for tax purposes when received as it would have been treated had it been received in the earlier years to which it relates. This approach is an extension of the analysis that would occur for determining source and character. In such a case, assuming that it was attributable to services performed abroad when the taxpayer was a nonresident alien, the argument would be that the dependent services article would cover the income.\(^\text{172}\) If the income arose in the foreign country, the United States could not tax it. It is unlikely that this argument would be successful. The better view is that treaty provisions are

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170. Treas. Reg. § 1.871-13(b) (as amended in 1980) (providing that foreign source income attributable to pre-U.S. residency period is taxable by the United States if it is received after the taxpayer becomes a resident).

171. See, e.g., I.R.S. F.S.A. 200139022, 2001 F.S.A. LEXIS 122 (Sept. 28, 2001) (finding that patent infringement settlement proceeds are treated as royalties).

172. U.S. Model Treaty, supra note 114, at art. 15.
to be applied in consideration of the taxpayer’s situation, including treaty eligibility, when the income becomes taxable, not in the year to which the income may be related.

This conclusion is not absolute, however, especially for compensation income. The United States does not interpret the dependent personal services article of the U.S. Model Treaty\(^\text{173}\) to be limited to income and services performed in the same tax year.\(^\text{174}\) Deferred income of a nonresident that is attributable to a year in which the nonresident was engaged in a U.S. trade or business, but is received in a subsequent year when the nonresident is not engaged in a U.S. trade or business, can be taxed by the United States under section 864(c)(6). The United States interprets article 15 of its treaties to incorporate the principles of section 864(c)(6) and would apply article 15 to income received in a subsequent year. Thus, if a nonresident received income that was related to a prior year, in determining which country had jurisdiction to tax the income, the taxpayer would first have to determine to which year the income was allocable and then apply the treaty provisions accordingly. Among the factors relevant to this determination are the number of days the nonresident was present in the United States and the identity of the payer of the compensation. Even though income received in one year can be taxed based on prior year facts, double taxation will not occur, provided that both countries treat the income similarly for source purposes. That is, income the United States treats as “arising” in the United States is treated as “foreign source” by the foreign country, and vice versa. This may have been the argument that the taxpayer’s counsel advanced in Private Letter Ruling 96-28-024, but because of the savings clause, was unsuccessful.

b. U.S.-U.K. Treaty

The most noteworthy development in the international tax treatment of compensatory options held by peripatetic executives is the diplomatic notes to the recently signed U.S.-U.K. tax treaty, which entered into force on

\(\text{173} \) Id.

\(\text{174} \) See U.S. Technical Explanation, supra note 118, at art. 15; Peter Blessing, Income Tax Treaties of the United States, ¶ 13.01[2][b][ix], 13.02[2][b][ix] (1996 & Supp. 2002). Even earlier treaties that contain language limiting residence basis taxation if the person is present in the other countries for 183 days or less in the year concerned, have been interpreted to refer to the tax year in which the services being compensated are performed in one state by a resident of another state and not to the tax year in which compensation is received. See Rev. Rul. 86-145, 1986-2 C.B. 297; Priv. Ltr. Rul. 93-32-038 (May 18, 1993).
March 31, 2003. The treaty endeavors to avoid double taxation by providing rules that characterize the option income for treaty purposes and then determine how it is allocated between residence and source countries.175

The notes establish that compensatory option income, which does not appear to include income from compensatory stock plans, is to be treated as compensation for purposes of the Treaty and subject to article 14, the dependent services article, as “other similar remuneration.”176 For persons who have received option grants in the course of employment in one contracting state177 and worked in both countries between grant and exercise, if the gain is taxed by both countries, double taxation is intended to be avoided by permitting the country of non-residence (at exercise) to tax only the proportionate amount of the gain that “relates” to services performed during the period of nonresidence.178 It is not clear whether both countries must tax the entire gain from the option, or only a portion must be double taxed. Presumably, any tax paid to the source country would be creditable under the relief from the double taxation article once the residence country recognizes that the source country has primary jurisdiction to tax with respect to a portion of the stock option income. Although the notes do not elaborate how the allocation of gain is to be done, e.g., whether on the basis of time or change in value of option, the U.S. Technical Explanation provides that the allocation is to be done on the basis of time worked in the respective countries.179

One reason that the option provision may have been included in the Treaty was the potentially significant number of option holders who perform services in both countries, given the extensive bilateral trade and investment

175. See Diplomatic Notes to the U.K.-U.S. Income Tax Treaty, reprinted at 4 Tax Treaties (CCH) ¶ 10,900C [hereinafter Diplomatic Notes].
176. U.S. Technical Explanation, supra note 118, at art. 14. The Joint Committee on Taxation Explanation states that article 14 is subject to the separate articles covering directors’ fees (article 15), pensions, social security, annuities, alimony, and child support payments (article 17), and government service income (article 19). If the option income was earned in any of these capacities, these separate articles would cover it. STAFF OF JOINT COMM. ON TAX’N, 108TH CONG., EXPLANATION OF PROPOSED TREATY BETWEEN THE UNITED STATES AND THE UNITED KINGDOM 40 (Comm. Print 2003). This treatment is, by its terms, limited to employee stock option income; thus, it does not appear to cover independent contractors and other non-employees. It is not clear why persons who receive options in a capacity other than as an employee or persons who are not employed when they exercise their options should be excluded.
177. The tax residence of the option issuer does not appear to be relevant.
178. Diplomatic Notes, supra note 175.
between the two countries. In addition, since the United States and the
United Kingdom generally tax options similarly, that is, both treat employee
stock option income as compensation, and exercise as a realization event, it
may not have been difficult to arrive at an acceptable allocation of tax
revenue.\textsuperscript{180} Where two countries take different views as to the timing,
source, and character of option income, arriving at an equitable allocation of
tax revenue may not be as easy. The issues raised by the U.S.-U.K. treaty’s
treatment of compensatory options are discussed below.\textsuperscript{181}

B. Conflicts Arising From Different Characterizations of Compensatory
Option Income

Example 5

U.S. resident alien (FP) receives NQOs from U.S. company, moves to
FC, a country that taxes options at grant, exercises after becoming an
NRA, and immediately sells the stock received. During the option-
holding period, the taxpayer performs services in the United States and
abroad. FC treats gain realized upon exercise of an option and sale of the
underlying stock as capital, and has source rules similar to the United
States.

1. U.S. Tax Rules

Once FP becomes an NRA,\textsuperscript{182} he will no longer be taxed by the United
States on his worldwide income.\textsuperscript{183} Income received after becoming an
NRA can still be taxed by the United States but only if the income
constitutes either U.S. source FDAP or U.S. source ECI.\textsuperscript{184} Since the
income earned by exercise of the option will be treated by the United States
as compensation, and FP performed services in the United States while he

\textsuperscript{180} See Inland Revenue, IR16 – Taxation of nonIR Approved Share & Option
Awards, available at http://www.inlandrevenue.gov.uk/pdfs/ir16.htm (last visited Nov. 4,
2003). For the taxation of the options issued to employees who change residence, see Inland
tb55.htm (last visited Nov. 4, 2003). Similar to the U.S. rules, the U.K. rules for option
taxation contain many variations.

\textsuperscript{181} See discussion infra Part VI.B.1.

\textsuperscript{182} The rules for determining the last day of residency are found in Treas. Reg.
\textsection 301.7701(b)-4(b)(2) (1992). The year of change of residency is treated as one tax year, but
the person is subject to two different tax regimes. See id. \textsection 1.871-13 (as amended in 1980).

\textsuperscript{183} Id.

\textsuperscript{184} I.R.C. \textsection 2(d) (West Supp. 2003).
owned the options, a portion of the income realized will be U.S. source ECI, unless a treaty exception applies.  

FP’s U.S. tax liability will depend on the U.S. source portion of the option income. There is no statutory formula for allocating the option income between U.S. and foreign sources. Current regulations require that in the absence of specific allocation, compensation should be allocated between U.S. and foreign sources “on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case.” The same regulation adds that apportionment on a time basis is acceptable.

There is no formal administrative or regulatory guidance addressing the U.S. tax consequences of a former resident alien who exercises NQOs received while a resident alien, in particular how gain is to be apportioned between U.S. and foreign sources once the option is exercised. Three private letters rulings, three field service advice memorandums, and one chief counsel advice address this issue, but do not reach uniform conclusions.

In Private Letter Ruling 87-11-107, the Internal Revenue Service ruled on the U.S. consequences to employees who had received restricted stock from a U.S. company and whose tax status had changed during the vesting period. The Internal Revenue Service, citing sections 864(c)(6) and 861(a)(3), ruled that, for post-1986 taxable years, “the place or places where the services were performed [sic] during the entire period of the restriction will determine the amount of effectively connected income and

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185. See id. § 861(a)(3) (treating compensation for services performed in the United States as U.S. source income); § 864(b) (providing that a U.S. trade or business includes performance of services in the United States at any time within the taxable year); § 864(c)(6) (providing that income received by NRA in year during which NRA is not engaged in a U.S. trade for business but which is attributable to year during which NRA was engaged in U.S. trades or business is treated a ECI).


187. Id. For some examples on how this is to be done, see id. § 1.864-4(b)(1)(ii) (as amended in 1986). This might not be appropriate in some circumstances. For example, assume that the employee earns a bonus based on particular services rendered in the foreign country, such as sales. In that case, it would probably be appropriate to allocate the bonus to foreign sources.


189. Id. The restricted stock of the U.S. parent company was subject to a five-year vesting period and to substantial risk of forfeiture because in the event that the employee terminated his employment within the five-year period, his stock was forfeited. Id. The ruling did not state whether the stock was publicly traded or how the final stock value was to be calculated. No section 83(b) elections were made by either U.S. or foreign persons and no income tax treaty applied. Id.
the source of the income” for persons who were nonresidents at the time the stock vested. The U.S. source portion of the income received upon vesting is calculated by multiplying the total compensation received from the vested stock by the ratio of the number of days during the vesting period that services were performed in the United States to the total number of days services were performed during the vesting period. The portion that is U.S. source is ECI under section 864(c)(6), even though it relates to prior years, including years for which the employee was a resident alien.

In Private Letter Ruling 90-37-008, the Internal Revenue Service addressed the tax consequences to employees of a foreign corporation and its U.S. subsidiaries who received NQOs, stock appreciation rights, or phantom restricted awards pursuant to various compensation plans offered by the parent and its U.S. subsidiary. The employees who had received the NQOs, SARs, or phantom restricted awards had performed services in the United States and abroad. The Internal Revenue Service ruled that income received under the various compensation plans was to be apportioned between U.S. and foreign sources based on the percentage of time services were performed in the United States and abroad during the applicable vesting period.

In Private Letter Ruling 6701305110A, the Internal Revenue Service ruled, for purposes of the section 911, on the allocation of option income of nonresidents who may have performed services in the United States after grant and before exercise. The options in the rulings were NQOs that vested one year after issuance in twenty percent installments. Thus, after six years, all of the options would be vested. For purposes of determining whether any of the option income would qualify as foreign earned income under section 911, the Internal Revenue Service ruled that any income realized upon exercise of the options would be attributable to the twelve month period preceding the date of vesting. In determining the U.S. portion of the option income of nonresidents who had performed services in the United States prior to exercise, the Internal Revenue Service ruled that

190. Id.
191. Id.
193. Id.
194. Id.
196. Id.
197. Id.
198. Id.
the U.S. source portion in the year of exercise would be determined by the percentage of days services were performed in the United States in the year of vesting.199 Given that the Internal Revenue Service in recent rulings has not followed the holdings of the ruling, it is unlikely that the conclusions reflect the current position of the Service.

In Internal Legal Memorandum 2002-15-010,200 the Internal Revenue Service addressed how option expense was to be apportioned for purposes of determining foreign sales corporation income. The taxpayer was an employer corporation that had granted compensatory NQOs that were exercised in the year following vesting.201 The memorandum concluded that the taxpayer could allocate in the year of exercise the option income based on the apportionment percentages for each year of the vesting period.202 The memorandum noted, however, that if there is a long period between vesting and exercise, the vesting period method might not be reasonable.203

The only other Internal Revenue Service guidance that addresses the allocation of option income between U.S. and foreign sources is a series of three field service advice memoranda issued between 1994 and 1996, in which the Service came to different conclusions regarding the application of section 864(c)(6) to a nonresident who received NQOs while a resident alien and exercised them while a nonresident. The first, Field Service Advice 940722,204 determined that section 864(c)(6) of the Code did not expand U.S. tax jurisdiction to allow a nonresident alien to be taxed as a resident with respect to options received while a resident, but merely permitted the U.S. source income of a nonresident to be treated as ECI instead of FDAP if it were received in a year during which recipient was not engaged in a U.S. trade or business.205 The field agent had argued that the option income should be taxed as if it had been received while the grantee was a resident alien.206 The field service advice did not address how the U.S. source portion was to be determined.

199. Id.
201. Id.
202. Id. The apportionment percentages were based on the percentages of time spent each year on foreign sales by the option grantees. Id.
203. Id.
205. Id.
206. Id.
One year later, Field Service Advice 950831\(^{207}\) concluded that section 864(c)(6) applied to both the U.S. and foreign source portions of the nonresident’s option income. After concluding that the option income was compensation, the Field Service Advice stated that the income was to be allocated between U.S. and foreign sources based on the respective number of days services were performed in the United States and abroad from grant to exercise.\(^{208}\) Because the nonresident appeared to have performed services in the United States in the year of exercise, the entire U.S. source portion was determined to be ECI not under section 864(c)(6), but rather under the general rule that performing services at any time in the United States causes all U.S. source compensation received in that year to be ECI.\(^{209}\) The foreign source portion was found to be ECI under section 864(c)(6). The rationale for the conclusion that the foreign source portion of the option income could be taxed is that the United States could have taxed the income had it been received in the year in which the taxpayer was a U.S. resident, but the author of the memorandum noted that “certain arguments may support a more narrow reading” of section 864(c)(6).\(^{210}\) Surprisingly, there was no mention of either Private Letter Ruling 87-11-107 or 90-37-008.

Almost a year later, Field Service Advice 960531\(^{211}\) modified the conclusions of Field Service Advice 950831 and Field Service Advice 940722 and concluded that section 864(c)(6) did not allow the United States to tax the deferred foreign source income of nonresident aliens even though the Field Service Advice acknowledged that the income would have been taxable had it been received while the person was a resident alien. The rationale appears to be that section 864(c)(6) merely removes the requirement that a nonresident alien be ETB before deferred U.S. source income attributable to a prior year in which the nonresident was so engaged.

\(^{208}\) Id.
\(^{209}\) Id.; see Treas. Reg. § 1.864-4(c)(6)(ii) (as amended in 1996). Although the dates are redacted in the FSA, the cited regulation and discussion leave little doubt that services were performed in the year of exercise. Also, there was no discussion of the $3000 limit under section 864(b)(1), but perhaps the amount of the option income, which was redacted, made that moot.
\(^{211}\) I.R.S. F.S.A. 960531, 1996 F.S.A. LEXIS 183 (May 31, 1996). The authors did not specifically address the issue of how the U.S. source income would have been taxable under section 871(b), rather than section 1 of the I.R.C., had it been received in a year during which the person was a resident alien. Although section 871(b) refers to section 1, the reference could be interpreted to refer only to the applicable tax rates, since the tax base of residents and nonresidents is significantly different.
can be taxed. Thus, it appears that the Internal Revenue Service interprets section 864(c)(6) to tax deferred income of a nonresident alien as if the person were always a nonresident. The conclusion reached in Field Service Advice 960531 and Field Service Advice 940722 accords with the holding of Private Letter Ruling 87-11-107; although, in both Field Service Advice rulings the deferred income was allocated over the vesting period for the restricted stock gains rather than the period from grant to exercise as in the case of stock option income.

From these sources, one can draw some tentative conclusions regarding the Internal Revenue Service's views of the scope of section 864(c)(6) and option income. For purposes of the source rules and in the absence of special circumstances, compensatory option income should generally be allocated ratably over the appropriate period, and divided between United States and foreign sources based on the percentage of days services are performed in the United States and abroad for each year. If the options are awarded for particular service, however, a different allocation method may be appropriate. Amounts that are foreign source cannot be taxed under section 864(c)(6), since foreign source service income can never be ECI. This is so even if the nonresident was formerly a resident alien and the deferred income would have been taxable had it been received while the taxpayer was a resident.

The Internal Revenue Service interprets section 864(c)(6) to apply to former resident aliens who receive *U.S. source* deferred income while a nonresident that is attributable to years of U.S. residency. None of the Internal Revenue Service rulings and memoranda, however, attempts to square that conclusion with the language of the statute. Section 864(c)(6) permits deferred income of a nonresident alien to be taxed, under section 871(b) of the Code, as ECI without the requirement of section 864(c)(1)(B), that the nonresident be EBT in the year of receipt if the income would have been taxable under section 871(b) had it been received in the year to which it is related. In the case of deferred income of a nonresident that is attributable to a year in which the person was a resident alien, it would not be taxable under section 871(b), but would be taxable under section 1. The intent of the statute is to tax a nonresident’s deferred income as it would have been taxed had it been received in the year to which it relates. By limiting section 864(c)(6)’s reach to U.S. source income of a nonresident alien that is attributable to periods of U.S. residency, the Internal Revenue Service potentially thwarts the aim of the statute – to remove any benefits from deferring income. It seems clear that Congress did not contemplate the application of section 864(c)(6) to former resident aliens; therefore, it is
questionable whether the statute should be extended to cover them. Of course, even without section 864(c)(6), the United States may tax deferred U.S. source income of a former resident alien as FDAP, but some older treaties may limit source basis taxation.

One remaining uncertainty is the period over which the option income is to be allocated. Based on the unofficial Internal Revenue Service guidance discussed above, it appears that the appropriate period could be either the vesting period or the period from grant to exercise. The new U.K.-U.S. Treaty, however, mandates allocation over the period from grant to exercise. This would appear to be the better rule. It has been suggested that allocation of income over the vesting period may better reflect the parties’ intentions regarding the period for which services are being compensated by the option or restricted stock, and that using the exercise date, rather than the vesting period, “seems to give the optionee an unexpected level of control.” For NQOs, there is no income to allocate until exercise. By not exercising the options at vesting, the employee is presumably performing services in the expectation of future appreciation; those services should arguably be taken into account in allocating any realized income. If an employer desires that options be intended to compensate the employee only until vesting, the option contract could be written to require exercise upon vesting.

Regardless of the period over which option income is to be allocated, the day-count method employed in all of the guidance has some merit. Tax liability can be easily determined since neither the number of days present in the United States nor the amount of compensation requires any subjective determination. If, however, an employee travels frequently and the vesting period is long, it could be burdensome to determine an employee’s daily physical location over a long period of time.

213. See supra note 118.
214. See Diplomatic Notes, supra note 175.
216. See Letter from Clarissa Dougherty & Arthur Hayes, PriceWaterhouseCoopers, to the Internal Revenue Service, available at LEXIS, Tax Analysts, Tax Notes Today, Mar. 29, 2000, 2000 TNT 102-24 [hereinafter PriceWaterhouseCoopers letter]. The combination of the day-count method and the general U.S. tax common law rule of not treating changes in tax jurisdiction as a taxable event, however, can result in significantly different U.S. tax liability for persons who have spent the same amount of time working in the United States but who are able to strategically time movements to and from the U.S. tax jurisdiction or accelerate
The day-count method, although easy to administer, is certainly not the only possible allocation method, and in some circumstances, it may be inappropriate. The regulations under section 861(a)(4) specifically countenance bases other than time to determine the U.S. and foreign portions of compensation. In fact, these regulations require apportionment to be done on the basis "that most correctly reflects the proper source of income under the facts and circumstances."217 One alternative method would be to tie the U.S. portion of compensation to changes in the value of the options during the period the person was present in the United States. This, too, would be a verifiably objective standard, provided that the underlying stock or options were publicly traded.218 The Internal Revenue Service, however, has recently proposed regulations that would mandate a time basis allocation of all an individual's compensation income, including fringe benefits, for services performed in the United States and abroad.219

income. For example, assume that two nonresidents receive stock grants and work in the United States ten percent of the vesting period. Just before the stock vests, one nonresident becomes a resident alien. Because the person will be a resident alien at the time the stock vests, he will be subject to tax on the entire gain although his colleague will be subject to U.S. tax potentially on only ten percent of the gain. This result occurs because the United States does not treat change of tax residency as a taxable event and almost all individual taxpayers are cash method taxpayers. Consequently, pre-residency accrued income and gain, to the extent received or realized after becoming a U.S. resident, are subject to U.S. tax in their entirety.

218. Difficult questions of valuation would arise if either the underlying stock or options were not publicly traded.
219. 65 Fed. Reg. 3401 (Jan. 21, 2000). The purported rationale for amending the regulation was that U.S. and foreign taxpayers were taking inconsistent positions with regard to fringe benefits received. Moreover, some U.S. taxpayers were treating fringe benefits received for foreign postings as foreign source income. Thus, taxpayers were avoiding tax liability under section 911. Yet, foreign persons with U.S. postings were allocating fringe benefits between U.S. and foreign source on the basis of time with the result that amounts allocated to foreign source were exempt from tax. Id. at 3402. In addition, taxpayers were taking different positions depending on how the fringe benefits were being accounted for — whether they were stated separately or included in gross compensation. Id. The proposed regulations are not limited to the determination of source solely of fringe benefits, but would apply to all compensation for "a specific time period . . . for labor or personal services." Id. For corporations, however, the facts and circumstances test would be retained. The preamble to the proposed regulations states that apportionment based upon payroll expenses or capital and intangibles employed may better reflect the proper source of such compensation. Id. at 3401 pmbl.

Even if proposed regulations are adopted, it may not be necessary to apportion income solely on the basis of time worked in the United States. The proposed regulations allow
In sum, under the facts of Example 5, it appears that the portion of FP's option income that is U.S. source – determined on a day count basis either over the vesting period or from grant until exercise – is treated as ECI under section 864(c)(6). Thus, FP is subject to U.S. tax at graduated rates under section 871(b), provided that the $3000 threshold is surpassed. The foreign source portion will be exempt from U.S. tax.\textsuperscript{220}

If FC also taxes the option income, it appears likely that none of the foreign taxes paid by FP would be creditable against any U.S. tax liability. Under section 906(a), a nonresident alien is only allowed a foreign tax credit if he is engaged in trade or business in the year the taxes are paid. Under the facts of Example 5, since FP performs services both in the United States and abroad, he may be engaged in a U.S. trade or business in the year the taxes are paid.\textsuperscript{221} Under section 906(b)(1), FP would not be allowed a credit for any foreign tax imposed on U.S. source income if the tax was imposed by FP solely on the basis of FP's tax residency in FC. Since under the facts of Example 5, FC would not tax FP's U.S. source income if FP were not a resident of FC, no credit would be available.

Even if the FC tax were not imposed solely because FP was a resident of FC, section 906(b)(2) provides that for purposes of determining the applicable foreign tax credit limitation of section 904, the only income that is relevant is effectively connected income. Applying this rule, a nonresident's foreign tax credit limitation will be the ratio of foreign source effectively connected income to U.S. and foreign source effectively connected income times the U.S. tax on the effectively connected income. Since under the facts of Example 5, FP does not have any foreign source effectively connected income, FP's foreign tax credit will be zero.

\textsuperscript{220} See supra text following note 211.

\textsuperscript{221} If no services were performed in the United States in the year of exercise, then the threshold requirements of the statute would not be satisfied and no credit would be available. Some commentators have argued that if income is taxed as if the person is engaged in a trade or business, section 906 should still be applicable. See Bittker & Lokken, supra note 153, at 72-159.
If FP were a U.S. citizen, the results would be slightly different. The option income would be subject to U.S. tax in its entirety because the United States taxes its citizens and resident aliens on their worldwide income.\footnote{222} To compute FP’s foreign tax credit limitation, the source of the option income would have to be determined under the same methodology discussed above for nonresident aliens. To the extent that services had been rendered abroad, either during the vesting period or from the grant date to the exercise date, that portion of the option income would be foreign source income and would fall into the general limitation basket. All foreign taxes paid with respect to the option income would be eligible to be credited against FP’s U.S. liability, depending on FP’s other income and foreign taxes in the general limitation basket.

2. Foreign Country Tax Rules

The foreign tax consequences will depend on how FC treats persons who change tax jurisdiction. If under FC law, the person and property are treated as if they were always subject to FC tax jurisdiction, the options could be treated as having a basis equal to their value determined under FC law on the grant date. If, however, FC disregards transactions that occur before a person becomes a FC resident, then the options would probably have a basis equal to zero.\footnote{223}

When the options are exercised and the shares are sold, the income is treated for FC purposes as capital gain because the compensatory element of the options terminated when the options were granted. Since the tax event occurs at the same time in both countries, the issue of foreign tax credit carryovers does not arise. The disparate characterization of the income—compensation by the United States and capital gain by FC—could affect the extent to which any foreign tax credit would be given. If FC treats the option income as capital gain, option exercise as a realization event, and adopts source rules for sales of personal property similar to the U.S. source rules, the option income would be FC source income.\footnote{224} If FC has a foreign tax

\footnote{222} Since the option income constitutes earned income, if the option holder elected the benefits of section 911, it could be exempt from U.S. tax. To the extent it was excluded under section 911 of the Code, there would be no foreign tax credit allowed with respect to the excluded income. I.R.C. § 911(d)(6) (West Supp. 2003).

\footnote{223} Similar issues arise if a taxpayer could have made a particular election with respect to the options, but no election was made because the person was not subject to FC tax jurisdiction when the options were granted.

\footnote{224} See § 865(a) (providing that the source of income from the sale of personal property is determined by the residence of the seller).
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credit regime similar to the U.S. regime, the foreign source option income would not increase the taxpayer's foreign tax credit limitation. In fact, it would marginally increase the taxpayer's worldwide income and, thus, decrease his foreign tax credit limitation.

There is one potentially troubling scenario that could arise: complete or partial exemption of the option income. If FC treats gain upon exercise of an option (or sale of the underlying stock) as a capital transaction and has a zero rate on capital gains, then the option income that was not taxed by the United States would not be taxed anywhere.

As the above discussion illustrates, double taxation can arise when two countries exert tax jurisdiction over the same income and characterize the income differently. For FP in Example 5, double taxation will arise because the United States does not grant a credit for foreign taxes paid on U.S. source ECI that are levied by FC on the basis of residence. Similarly, FC does not grant a tax credit for U.S. taxes on the U.S. source income because FC characterizes the income as domestic source.225 For a U.S. citizen or resident alien in the same economic position as FP in Example 5, double taxation is mitigated by the possibility of a U.S. foreign tax credit. Double taxation can still arise, to the extent that the option income is U.S. source income and FC taxes the entire amount of option income on a residence basis and characterizes it as domestic source.226

3. Income Tax Treaty Rules

If there is a tax treaty between the United States and FC that is similar to either the U.S. or OECD Model Treaty, double taxation of former resident aliens, such as FC in Example 5 and U.S. citizens and resident aliens residing in FC, can still arise. The extent to which a treaty mitigates double taxation depends on how the respective treaty parties characterize the income. Unless a treaty specifically provides a rule for characterizing the option income, as in the case of the U.S.-U.K. Treaty,227 each country in Example 5 would generally apply its internal tax law to characterize the

225. If gains from the sale of personal property could be treated as non-FC source under the tax law of FC, then the U.S. taxes paid by the option holder could potentially be used to offset FC taxes.

226. Assume that the option income is $100 – 50% is U.S. source and the U.S. and foreign tax rates are 30% and 20%, respectively. The U.S. foreign tax credit limitation is $15 [$50/$100 x $30], but $20 of foreign taxes have been paid. The remaining $5 can be carried back or forward under section 905(c).

realized income. Consequently, it is possible that FC would treat the income as falling under article 13, the capital gains article, whereas the United States would look to article 15, the dependent services article.

The United States would be foreclosed from taxing the option income if the requirements of article 15(2) were satisfied, although it is unlikely that all of the requirements could be satisfied. In particular, it is unlikely that FP would have been present in the United States for fewer than 184 days for all of the relevant taxable years. Moreover, if the options were granted by a U.S. company, when the options were exercised, the U.S. company would get a compensation deduction, which by itself would permit the United States to tax the U.S. source portion. It is unlikely that FP could rely on the treaty to obtain a U.S. foreign tax credit for FC taxes paid, since U.S. tax treaties generally only permit a tax credit in the same circumstances as does the Internal Revenue Code.

It is unclear whether an FC tax credit would be available under a treaty, assuming that both the residence and source countries followed the OECD Model Treaty and commentary. If FC treats the option income as falling under article 13, the capital gains article, and the United States treats it as falling under article 15, the compensation article, FC may be required to grant a credit for source basis taxation if the disagreement is treated as a "conflict of qualification." That is, if, due to differences in domestic law, the source and residence countries apply different treaty provisions, the OECD commentary treats the source country as taxing the income in accordance with the treaty and, thus, requires the residence country to grant a credit for source basis taxes. If, however, the residence country considers the source country to be interpreting and applying the treaty incorrectly – a


229. If FP were employed by a foreign subsidiary of the U.S. option grantor when the options were exercised, the stock is first deemed exchanged by the parent in exchange for cash equal to the value of the stock, and then the stock is exchanged for cash from the option holder. Treas. Reg. §§ 1.83-6(d) (as amended in 2000), 1.1032-3(b)(1). If the option holder or subsidiary pays for the stock, this amount reduces the amount that is deemed contributed by the parent and the resulting basis increase in the subsidiary’s stock. Id. §1.1032-3(c) ex.8. In order to receive this tax-free treatment, certain conditions must be met. See id. § 1.1032-3(c). This deemed cash purchase model ensures that the subsidiary corporation upon exercise recognizes no gain. The deduction for compensation is available to the subsidiary upon exercise. It is unlikely in this case that the remuneration would be considered to be paid by a resident of the United States. See Michael Vanesse, Global Equity Plans – The Challenges of Implementation, 14 BENEFITS L.J. 39 (2001).

230. OECD Model Treaty, supra note 15, ¶32.3 cmt., arts. 23A, 23B reprinted in 1 Tax Treaties (CCH) ¶ 214A [hereinafter OECD Commentary].
"conflict of interpretation" – the residence country would not have to credit source basis taxes. The OECD Report acknowledges both arguments and recommends resolving the issue by treating option income as being subject to article 15.

For a resident alien or U.S. citizen residing in FC, the treaty analysis is slightly different. Under all U.S. treaties, the United States reserves the right, under the "savings" clause, to tax its citizens and residents as if the Treaty had not come into effect. The relief from the double taxation article generally contains a mechanism to avoid double taxation in the case of mutual exertion of residence basis taxation where the U.S. foreign tax credit would not relieve double taxation, i.e., when both FC and United States tax U.S. source income. Treaties typically accomplish this by requiring the country of residence to grant a credit for U.S. taxes on U.S. source income, as determined under the treaty. The United States, however, must then grant a credit for FC taxes paid on the U.S. source income, which is accomplished by resourcing a portion of the U.S. source income to be foreign source income. As long as both countries treat the option income similarly for source purposes, double taxation is avoided. If FC treats the option income as capital gain, however, and argues that it cannot be taxed by the source state under the U.S. Model Treaty, no credit would be given by FC against the income and double taxation would not be avoided.

VI. MITIGATING INTERNATIONAL DOUBLE TAXATION

This section explores various approaches that administrators and legislators could consider adopting to reduce the possibility of international double taxation or exemption arising when holders of compensatory options perform services in more than one country or change tax jurisdiction during the life of the option. Adopting measures that provide greater tax certainty for peripatetic employees reduces costs to companies and employees that no longer have to engage in wasteful pre-immigration tax planning, unnecessary self-help transactions, or agree to bear the cost of any double taxation,

231. Id. at ¶ 32.5.
232. See discussion infra Part VI.B.
234. Id. at art. 24.
235. Id. For a detailed example, see, e.g., U.S. Technical Explanation, supra note 118, at art. 24.
236. Examples of such measures include reissuing options, arranging sales of the options, or the substitution of other types of deferred compensation for options.
which should, in turn, help promote the freer cross-border migration of persons. Furthermore, the approach taken to mitigate double taxation for holders of compensatory options who change tax jurisdiction may be useful for resolving other tax issues that arise when persons change tax jurisdictions. One important consideration is whether the United States should adopt these measures unilaterally or, instead, only as part of bilateral treaty negotiations.

A. Unilateral Measures

1. Modification of U.S. Foreign Tax Credit Regime

As Examples 1-3 above illustrate,237 double taxation can result when a taxpayer changes tax jurisdiction and the same income is taxed by two countries on a residence basis as a result of different timing rules. To alleviate double taxation, consideration should be given to modifying the U.S. foreign tax credit rules, but in a manner that properly protects U.S. fiscal interests. There are various approaches that legislators or administrators could take to provide relief. One approach, which is consistent with U.S. practice regarding change of tax jurisdiction generally, would be to treat the taxpayer as a U.S. person ab initio and apply the same foreign tax carryforward and carryback rules for U.S. citizens and residents upon a change in tax residence. Thus, foreign taxes paid in a pre-U.S. residency year could potentially be carried over to a year in which the person was a resident alien. This approach, however, could produce a windfall if the income that generated the foreign taxes paid in a pre-U.S. residency year was not also carried forward. Furthermore, if a country had a higher tax rate than the United States, excess foreign tax credits could potentially be carried over and used to offset U.S. taxes on future foreign source income in the same basket.

Assuming that section 905(c) cannot be interpreted to permit the carryover of foreign tax credits from pre-U.S. residency tax years, there are policy reasons why such carryovers should be permitted in limited circumstances. In particular, consideration should be given to permit the carryover of foreign taxes that were paid while a person was a nonresident if the income that gave rise to the taxes is subsequently taxed by the United States on a residence basis.

It is important to distinguish this proposal from one that would allow the unlimited carryover of foreign taxes paid by a nonresident who later

237. See supra pp. 204-06.
becomes a U.S. resident (or the unlimited carryback of taxes paid when the person becomes a nonresident after being a U.S. resident). Under this proposal, no foreign taxes would be potentially creditable if they were paid with respect to foreign wages or gains from property transactions realized while the taxpayer was a foreign resident, unless the United States also taxed the income after the person became a U.S. resident. Allowing unlimited carryover of foreign taxes appears, at first glance, to be consistent with the general U.S. rule applicable to persons changing U.S. tax jurisdiction, in that they would be treated as if they were always subject to U.S. residence jurisdiction. It would be inappropriate to apply this approach to foreign taxes paid by a person when he was not subject to U.S. residence basis taxation. The purpose of the U.S. foreign tax credit rules is to prevent double taxation that arises from the (generally simultaneous) exertion of both residence and source taxation with respect to the same income. Under United States' rules, the source country – as determined under U.S. tax principles – generally has primary jurisdiction and the residence country secondary or residual jurisdiction. For this reason, the United States generally permits a foreign person, who is taxed by the United States on a source basis, a credit for foreign taxes paid with respect to foreign source ECI. Foreign source income of foreign persons is not taxed by the United States, except for limited categories of foreign source ECI. Consequently, for purely foreign items, such as wages or property transactions that arose when the foreign person was not subject to U.S. residence basis taxation, double taxation does not arise since the United States does not exert any tax jurisdiction over the income, and therefore, the United States should not provide relief. In essence, allowing a U.S. foreign tax credit for residence basis taxes paid to another country, when the income is again taxed on a residence basis by the United States, treats the formerly foreign person as if he had always been subject to U.S. tax jurisdiction, but only with respect to a limited category of transactions, i.e., ones that straddle a change in tax residency because of timing differences.

Adopting this approach for foreign taxes would require tax administrators to consider certain ancillary issues. For example, should foreign taxes paid in a pre-U.S. residency year be allowed to offset post-U.S.

238. See supra Part V.A.1.a.
240. Id. § 864(c)(4) (listing limited categories of foreign source ECI).
241. Under current law, a nonresident who becomes a resident alien may be able to achieve a better result by deferring payment of foreign taxes until after becoming a U.S. resident. See supra note 157.
residency income? How many years should a taxpayer be allowed to carry forward income? How should the source rules be applied, since the source of income rules sometimes focus on the underlying economic activity, in which case the residency of the taxpayer does not matter, but sometimes focus on the residence of the taxpayer? One possible solution would be to assign the income and associated foreign taxes to a separate foreign income basket, with appropriate adjustments to the source of income rules. This would prevent such taxes from offsetting subsequently earned foreign source income and would obviate the need to be concerned about carryovers, since once the income was taxed by the United States, if the associated foreign taxes were not creditable they would perforce expire, since there could never be any other income in that basket. In addition, under this approach, there would be no need to worry about conflicting characterizations of the income for U.S. and foreign purposes.

One important consideration is how the income should be sourced. In Example 1, assume that both the option value at grant (taxed by FC) and the difference between the exercise price and stock value (taxed by the United States) are $20, and FP performs one-half of his services in the United States. If the foreign taxes of $7 (35% of $20) can be carried over, and U.S. tax principles apply to determine FP’s foreign tax credit, only $3.50 of the foreign taxes would be creditable. Thus, there will still be double taxation on $10 of the income taxed by FC. Double taxation will occur to the extent that any services are performed in the United States, the foreign country treats all of the option income as domestic source, and the United States uses U.S. tax principles to determine the U.S. foreign tax credit. The use of U.S. tax principles to determine the respective components of the U.S. foreign tax credit is firmly entrenched in United States’ jurisprudence and should not be abandoned in this case. As this simple example illustrates, for double taxation arising when a person changes tax

242. Compare § 861(a)(3) (providing that the source of compensation is determined by where services are provided), with § 865(a) (providing that the source of gains from the sale of personal property is determined by the residence of the seller, as defined in section 865(g)).

243. See supra p. 204.

244. This would be calculated as follows: $10 (foreign source income)/$20 (worldwide income) times $7 (U.S. tax pre-credit).

245. See United States v. Goodyear Tire & Rubber Co., 493 U.S. 132, 145 (1989) (agreeing that “tax provisions should generally be read to incorporate domestic tax concepts absent a clear congressional expression that foreign concepts control”); Biddle v. Comm’r, 302 U.S. 573, 578 (1938) (reasoning that because “the power to tax and to grant credit resides with Congress,” U.S. law should control unless the statute states otherwise).
jurisdiction and the same income is taxed on a residence basis by both countries, treaties may be the best alternative to mitigate double taxation.

2. Giving Deference to Prior Foreign Tax Events

Another approach that the United States could consider adopting in taxing cross-border compensatory options would be to defer to the foreign country’s tax treatment of the option. In the case of an option granted to a foreign person not subject to U.S. tax jurisdiction, or to a U.S. person subject to foreign tax jurisdiction, and taxed at grant by the foreign country, the foreign country’s timing rules would apply even if the option holder or income were subsequently taxed by another country. This approach would eliminate concerns about the proper treatment of previously paid foreign taxes, as double taxation would be mitigated by basis adjustments.246 Thus, in Example 1, if an option were taxed at grant by a foreign country, double taxation would be avoided because the United States would include the amount that was previously taxed by FC in the basis of the option. Since the United States would tax only the amount in excess of the option’s basis, no international double tax would occur. U.S. tax consequences of foreign transactions often follow from legal obligations and rights imposed by foreign law.247

In spite of the ostensible appeal of giving deference to foreign law tax events, it would be unsound policy for the United States to abandon its long-standing common law approach of not giving effect to foreign tax law for purposes of determining the consequences relating to an item of income for U.S. tax purposes. First, U.S. tax authorities would have to be knowledgeable enough about the details of foreign tax law to determine whether the transaction was properly reported. Second, depending on its implementation, this approach could require the United States to abandon

246. Permitting both a basis adjustment and foreign tax credit would inappropriately result in a double benefit. For example, assume property is bought for $10 and deemed sold for $20 in a foreign country, and the owner moves to the United States and sells the property for $20. If the United States allowed a credit for $10 and a basis of $20, the $10 of gain (as computed under U.S. common law tax principles) would escape U.S. tax forever, but the taxpayer could use the credit to offset U.S. tax on other foreign source income. The taxpayer would receive a total tax benefit of $20. Instead, if the person were to compute gain under U.S. tax principles, there would be a gain of $10, which is taxed by both the United States and the foreign country. Permitting the taxpayer a credit for these taxes paid would be appropriate to relieve double taxation.

taxing option income that has a significant economic nexus to the United States. For instance, if FP in Example 1 immediately moved to the United States after being granted the options and exercised them years later after working only in the United States, the United States could not tax any of the income previously taxed by FP. Third, a U.S. person and a foreign person who received the same options as in Examples 1 and 2, could be taxed differently by the United States. FP would have no residual U.S. tax to the extent that the exercise price plus the amount previously taxed by FC was less than the value of the stock received. If this approach only applied to foreign persons, USP could have residual U.S. tax liability depending on the amount of foreign source income he earned (either from the option income or elsewhere). Fourth, using basis adjustments to alleviate double taxation would diminish the role of the foreign tax credit, which Congress has determined is the best mechanism to relieve double taxation. By continuing to follow the common law approach of not giving effect to foreign tax law for U.S. tax purposes, except in special circumstances, the United States best maintains control over its fiscal policies and revenues, thus permitting the Code to best reflect Congress’ view of the socially optimal balance of equity and efficiency.

3. Mark to Market

As has been argued elsewhere, serious consideration should be given to modifying the common law rule that treats change of tax jurisdiction as a nonevent and instead, for property that is brought into (or removed from) U.S. tax jurisdiction, when the property's owner becomes subject to (or leaves) U.S. tax jurisdiction, change of tax jurisdiction should be treated as a taxable event. If this rule were adopted, the United States could tax only gains (and would only permit deductions for losses) that accrue while the person was subject to U.S. tax jurisdiction. Treating a change in tax jurisdiction as a taxable event, however, should not be seen as altering the rule of United States supremacy regarding foreign tax events. For example, the acquisition of a capital asset would still be treated as a nondeductible capital expenditure regardless of the foreign tax treatment. This approach merely eliminates pre-change of tax residency gain or loss, as determined solely under U.S. tax principles.

It is unclear how compensatory options would be treated under a market-to-market regime. Canada, which has adopted such a regime, and which taxes compensatory options similarly to the United States, does not subject

248. See Colon, supra note 140, at 60-88; Engel, supra note 140, at 319-22.
them to mark-to-market treatment.\textsuperscript{249} U.S. legislators have shown great reluctance to implement a mark-to-market regime for persons beginning, or ceasing, to be taxed on a residence basis by the United States, even though the failure to adopt a limited measure of such a regime permits built-in gain on appreciated assets that leave U.S. tax jurisdiction to escape U.S. tax and built-in loss on imported assets to shelter U.S. tax.\textsuperscript{250} The fact that these problems are well known and Congress has considered the issue in great detail suggests that even a limited mark-to-market approach will not be adopted soon. It is unlikely that, without Congressional sanction, tax administrators could adopt such an approach unilaterally.\textsuperscript{251}

\textbf{B. Treaty Measures to Relieve Double Taxation}

Individual countries may take steps to mitigate double taxation that arises when a person holding compensatory stock options changes his tax residence, but, as discussed above, the relief may be either one-sided or incomplete. Because of the conflicting international approaches to taxing compensatory option income, the best mechanism to resolve these conflicts may be through the bilateral treaty process. Through the treaty process, both parties can ensure that benefits and burdens are fairly shared. Also, through negotiations, the parties can tailor relief that can flexibly accommodate any idiosyncrasies of domestic law.

There are some drawbacks to using the treaty process. Individual treaties are renegotiated usually once every generation, although treaty amendments are not nearly as infrequent. Furthermore, once there is an international consensus as to how compensatory stock option income should be treated for

\begin{itemize}
\item \textsuperscript{249} Income Tax Act, R.S.C., ch. 1, § 128(10) (1985) (Can.). For a discussion of the Canadian taxation of stock options, see Daniel Sandler, \textit{The Tax Treatment of Employee Stock Options: Generous to a Fault}, 49 CAN. TAX J. 259 (2001). Compensation is not subject to market-to-market taxation; instead, it is taxed on a cash basis, even though it is attributable to services rendered prior to becoming subject to Canadian tax jurisdiction. The treatment of compensation attributable to services rendered prior to entering Canadian tax jurisdiction is inconsistent with that of built-in gains on capital assets, but may have been adopted for administrative simplicity reasons. Since it could be burdensome for a person entering (or leaving) Canadian tax jurisdiction to have to prorate ordinary income items such as interest, rent and royalties between periods of Canadian and non-Canadian residency, it is easier to retain the cash basis treatment of these items. Also, since most compensatory options are not publicly traded, there would arise difficult issues of valuation.
\item \textsuperscript{250} See Peter A. Glicklich \& Abraham Leitner, \textit{Loss ‘Importation’ – Opportunities and Limitations}, 82 TAX NOTES 1051, 1052 (1999).
\item \textsuperscript{251} But see Prop. Treas. Reg. § 1.1291-3(b)(2), 57 Fed. Reg. 11024 (Apr. 1, 1992) (treating a change in U.S. residency as a disposition a section 1291 fund).
\end{itemize}
treaty purposes, a country that may lose revenue by agreeing to a treaty containing certain terms, may simply not agree to include the provision, or if the OECD Model Treaty commentary is amended, may simply enter a reservation for a particular provision. On the other hand, since in many countries the taxation of compensatory options is not long-standing, perhaps an international consensus may stimulate legislators to reconsider their domestic laws to bring them more in accordance with treaty principles. Of course, it is not inconceivable that a country would maintain oppressive domestic tax policies in order to extract more concessions from a potential treaty partner. This portion of the Article examines the treatment of compensatory options under the new U.S.-U.K. Treaty and then discusses the approach advocated by the OECD.


The new U.S.-U.K. Treaty252 is the first tax treaty to specifically address compensatory stock options. If a treaty resident suffers double taxation and works in both countries between grant and exercise, the source country has primary tax jurisdiction, but only for the proportionate amount of option income related to services performed in the source country.253

From a U.S. tax perspective, the Treaty does not appear to modify significantly the results that would occur in many instances in the absence of the Treaty. Take for instance the example of a U.S. citizen who receives options and moves to the United Kingdom and exercises his options. Article 14 of the U.S.-U.K. Treaty, if read in isolation, would appear to allow the United States to tax only the portion of the gain attributable to the period of U.S. residence. The savings clause of article 1 of the Treaty, however, provides that the United States can tax its residents (as defined in the Treaty) as if the Treaty had not come into effect. If the diplomatic notes are interpreted to not override the savings clause, the United States could then also tax the entire amount, but would be required to grant a credit for any U.K. taxes paid, subject to the requirements of article 24 of the Treaty.254 This result, however, would occur regardless of the application of the Treaty because the United States taxes its citizens on a residence basis, permits a credit for source basis taxation, and, under some authority, allocates option income ratably over the period from grant until vesting for source

253. See Diplomatic Notes, supra note 175.
254. The technical explanation provides that article 14 is subject to the savings clause. U.S. Technical Explanation, supra note 118.
purposes. The same conclusion would hold for a former U.S. resident who moves to the United Kingdom and exercises compensatory stock options. The United States, under section 864(c)(6), would exert source basis taxation over the U.S. source income, which would be determined by the percentage of days worked in the United States.

Although the Treaty provides some welcome guidance for peripatetic option holders and perhaps for tax administrators, its provisions seem somewhat limited and the tax treatment that should apply to some option holders is unclear. What if an option holder does not satisfy all of the listed requirements – for example, the requirement that the option holder be employed when she exercises her compensatory options? Is the Treaty option provision still applicable?

The application of the Treaty to ISO holders is also uncertain, since the interaction of the ISO provisions and section 864(c)(6) is ambiguous. Section 864(c)(6) applies to “income attributable to ... the performance of services.” Although ISO gain is taxed as a disposition of a capital asset, since ISOs are granted solely in an employment relationship, ISO gain may still be treated as income attributable to the performance of services for purposes of section 864(c)(6) of the Code. If ISO gain were covered by

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255. See supra Part V.B.1.

256. For options granted to a person not ordinarily a resident in the United Kingdom but who becomes a U.K. resident and then exercises the options, there is generally no U.K. tax upon exercise, unless there is a connection between the option grant and U.K. employment. There will be capital gains tax on any gain realized upon the sale of the shares. U.K. tax authorities have stated that they will treat gain realized upon the sale of shares as compensation income for treaty purposes and allow a tax credit for foreign taxes paid at exercise. See The Taxation of Share Options: Internationally Mobile Employees, 55 Tax BULLETIN 883-86 (2001), available at http://www.inlandrevenue.gov.uk/bulletins/tb55.pdf (Oct. 2001).


It has long been recognized that the transfer of stock to an employee pursuant to the exercise of a nonstatutory stock option granted in connection with employment constitutes a payment of compensation to the extent that the fair market value of the stock received by the employee pursuant to the exercise of the nonstatutory option exceeds the option exercise price. Commissioner v. LoBue, 351 U.S. 243 (1956); Commissioner v. Smith, 324 U.S. 177 (1945). The exclusion from gross income for income tax purposes that is provided by section 421(a)(1) for the transfer of stock upon the exercise of a statutory stock option, does not alter the compensatory character of such stock transfers or serve to distinguish statutory stock options from nonstatutory stock options for purposes of sections 3121(a) and 3306(b).

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section 864(c)(6), a nonresident who earns ISO income would be subject to U.S. tax on the U.S. source portion of the gain. This would likely be determined similarly to NQO gain, except that the gain would probably be allocated over the period from grant to sale of the underlying stock, rather than from grant to exercise as in the case of NQOs. If, on the other hand, ISO income was not covered by section 864(c)(6), it would be treated as capital gains exempt from U.S. tax in the hands of a nonresident. In such a case, the Treaty would be irrelevant.

If ISO gain were treated for purposes of section 864(c)(6) as compensation, a nonresident alien who earned U.S. source ISO income would be taxable in the United States upon a sale of the shares. In addition, if the nonresident exercised the ISO while a resident of the United Kingdom and sold the underlying stock, the United Kingdom would also tax any gain realized upon a sale of the shares. The statement in the Treaty that “option gain” is to be treated for treaty purposes as “other similar remuneration”\(^\text{258}\) is broad enough to encompass ISO gain, even though under U.S. law, gains from ISOs are treated as dispositions of stock, a capital asset.\(^\text{259}\) It is unclear how such double taxation is to be handled under the Treaty, since the Treaty seems to focus on exercise as the taxable event. Specifically, since the sale of the shares is a taxable event, it is unclear whether income should be allocated between the source and residence countries over the period from grant until sale or from grant until exercise. The fact that exercise is not a realization event in both countries suggests that the provision may not have been intended to apply to ISOs.

The relationship of the option provisions to the other sections of article 14 is unclear. Are the option provisions intended to be read separately from paragraph 2 of article 14 of the Treaty, which prevents source basis taxation

\(^{258}\) See Diplomatic Notes, supra note 175.

\(^{259}\) The treatment of ISO income for foreign tax credit purposes is unclear. Compensation income generally falls into the general limitation basket of section 904(d)(1)(I), but ISO gain is capital, which may result in the income falling into the passive basket of section 904(d)(1)(A) of the Code. If the Internal Revenue Service were to require that ISO income be placed into the passive basket rather than the general limitation basket, it could be difficult to also argue that it should be governed by article 14 of the U.S.–U.K. Treaty rather than article 13 of that Treaty, the capital gains article. If, however, the income were taxed at a rate higher than the highest rate in section 1 of the Treaty, it would be kicked out of the passive basket into the general limitation basket pursuant to section 904(d)(2)(F). It is generally preferable for income to fall into the passive basket. Since foreign countries generally do not tax passive income, the taxpayer is likely to not have any excess credits in the passive basket. The mechanics are set out in Treas. Reg. §§ 1.904-4(b), (c) (as amended in 2001).
if certain requirements are met? Source basis taxation for service income is permitted unless the recipient and income satisfy certain conditions in paragraph 2. If the options provisions were to be read separately from the other paragraphs of article 14, source basis taxation would be permitted with respect to option income to the extent that services were performed in the source country, whereas it would not be permitted for other deferred income if the requirements of paragraph 2 were satisfied.

Finally, the option provisions appear only to provide guidance for income from option plans and not other common types of equity-linked deferred compensation, such as restricted stock plans. The tax policy reflected in the option provisions seems to be that option income should be treated as service income since the options were granted in the employment context. Furthermore, the option income should be treated as accruing ratably over the period from grant to exercise, since exercise is treated as a taxable event and the shares received can generally be freely sold. Applying this rationale to restricted stock, it would seem reasonable to treat the income from restricted stock as compensation and allocate it over the period from grant until vesting.260

Section 83(b) elections for restricted stock raise additional issues. If a recipient of restricted stock were a U.S. resident and made a section 83(b) election, and subsequently moved to the United Kingdom and sold the stock once it vested, the United States would treat any subsequent gain not as compensation income but as capital gain. The United Kingdom, however, would disregard the section 83(b) election and tax the entire amount as compensation when the shares vest.261 Given the uncertainty regarding the source of income realized upon making a section 83(b) election, the person making the election may suffer unrelieved double taxation.262

The issues involving section 83(b) are potentially quite important. Not only can it apply to restricted stock received outright, but section 83(b) has

260. Banoff & Lipton, supra note 215.

261. If the United Kingdom were to tax the income, any taxes paid should be creditable by the U.S. person. Since the United States would treat the income as capital gains from the disposition of personal property, the credit would only be potentially beneficial if the capital gains were foreign source. The source of gain for personal property is based on the tax home of the taxpayer. I.R.C. § 865(g)(1)(B) (West Supp. 2003). In addition to having a foreign tax home, the taxpayer must pay foreign tax of at least 10% in order for the gain to be foreign source. Id. § 865(g)(2).

262. For purposes of section 911, a taxpayer who makes a section 83(b) election may elect: (1) to treat the entire amount included in income as attributable to the year in which section 83(b) election is made; or (2) to include a proportionate amount in income over the vesting period. Treas. Reg. § 1.911-3(e)(4)(iii) (1985).
become an important planning tool for founders of start-up companies to attempt to convert potential ordinary income from stock options into capital gains by exercising their options soon after receiving them and receiving restricted stock with respect to which a section 83(b) election is made. In addition, under current accounting rules, restricted stock grants suffer more unfavorable accounting treatment than compensatory options because the stock grant is treated as a current expense. If the accounting treatment of compensatory options is changed so that they are treated similarly to restricted stock, restricted stock grants may significantly increase in popularity.

2. OECD Report

Given the growth of compensatory stock option grants, the increased international mobility of employees, and the need for more uniform international tax principles, the OECD recently released a revised, detailed report addressing the tax issues that arise when an employee who holds stock options and performs services in more than one country is taxed by more than one country. The report identifies how domestic law differences in timing, character, allocation, and source can give rise to double taxation and proffers various proposals and amendments to the commentary to the OECD Model Treaty to mitigate double taxation.

The importance of the OECD Report cannot be overestimated. OECD reports form the basis for subsequent model treaty commentary changes and have become de facto international tax treaty jurisprudence. In construing treaty terms, even U.S. courts treat the OECD commentary as a type of legislative history, and have even applied it retroactively. Also, for countries whose domestic tax rules do not accord with the OECD approach,

263. See Gilson & Schizer, supra note 107.
264. See supra Part III.
265. OECD Report, supra note 17.
266. The OECD Report proposes changes to the commentary to articles 13, 15, 16, 23A and 23B of the OECD Model Treaty.
the report may compel them to consider amending their domestic law to conform to the OECD norms. This section discusses the Report.

a. Timing of Option Income

For option income that two countries characterize similarly, e.g., as compensation, but tax at different times, the OECD Report suggests that double tax could best be relieved through application of article 23, the double tax article, with the source country having primary tax jurisdiction and the residence country secondary.\textsuperscript{268} To implement this approach, the report suggests amending the commentary to article 15 of the OECD Model Treaty to clarify that income attributable to services performed in the source country can be taxed by the source country even though the person is no longer rendering services in the source country when the income is received.\textsuperscript{269} Likewise, the report suggests amending the commentary to article 23 to provide for a temporally unlimited carryover and carryback of foreign tax credits so that the residence country would credit source basis taxes even though they were paid in a different year.\textsuperscript{270} These modifications are consistent with U.S. law, except that the carryover and carryback period for foreign taxes under U.S. law is limited to two and five years, respectively.

If double taxation arises merely because of timing differences, the suggested amendments put forth in the OECD Report would mitigate double taxation, provided both the source and residence countries' treaty follows the wording of the OECD Model Treaty. Differences in timing, however, will rarely be the sole cause of double taxation. When two countries tax an employee option at different times, it is generally because each treats the compensatory portion as terminating at a different period in the life of the

\textsuperscript{268} OECD Report, \textit{supra} note 17, at ¶ 15. There are actually two double taxation articles, 23A and 23B of the OECD Model Treaty, each of which addresses two distinct approaches to relieving double taxation, the exemption and credit methods. The main difference between the two is that in an exemption system, the taxpayer will pay tax only at the source country rate, whereas under a credit system, the taxpayer will pay the higher of the source or residence country rate. There are variations on both methods. \textit{See} OECD Commentary, \textit{supra} note 230, at ¶ 18-27. In its treaties, the United States generally allows a foreign tax credit pursuant to its domestic law for source basis taxation.

\textsuperscript{269} The report would allow the source country to tax under article 15 income that is derived from "the exercise of employment" in the source state, regardless "when that income may be paid to, credited or definitively acquired by the employee." OECD Report, \textit{supra} note 17, at ¶ 17.

\textsuperscript{270} \textit{Id.}
option. The amount of the option income characterized as compensation and the source and allocation of that income between the source and residence countries will certainly be different as well, thereby causing double taxation. The issues of character, source and allocation must first be addressed to avoid double taxation.

b. Character of Option Income

To prevent conflicting characterizations of option income that arise when countries terminate the compensatory component at different times, the OECD Report recommends limiting the application of article 15 to option income that arises between grant and exercise;\(^{271}\) any income arising from the sale of the shares received would fall under article 13, the capital gain article.\(^{272}\) If the shares received at exercise were not fully vested, article 15 would apply to any post-exercise appreciation until vesting.\(^{273}\) This approach mirrors the United States' treatment of NQOs.\(^{274}\)

The OECD Report explicitly states that the division of option-related income between articles 13 and 15 applies only for purposes of a treaty, and no country must necessarily change its domestic law treatment of option income.\(^{275}\) Thus, a country that taxes option income at capital gains rates when the shares received are disposed of, as in the case of ISOs in the United States, would not be forced to change its domestic law, but if it were the state of source it could only tax under article 15 the portion of the final income attributable to the option, presumably the difference between the exercise price and fair market value of the stock at exercise.\(^{276}\) Although the OECD Report ostensibly recognizes each country's fiscal sovereignty to tax option income in accordance with its domestic tax policy, for international employees the OECD approach will, in essence, supplant any contradictory domestic law.

Concluding that income from employee stock options is inherently compensation, rather than capital gains, is an important analytical step in

\(^{271}\) Id. at ¶ 23, 26. If the option is sold or otherwise disposed of prior to exercise, the compensation period terminates at the earlier time.

\(^{272}\) Id.

\(^{273}\) Id. at ¶ 26 (referring to the suggested addition of ¶ 12.3 to the Commentary on article 15).

\(^{274}\) See supra Part IV.B.2.

\(^{275}\) OECD Report, supra note 17, at ¶ 26 (referring to the suggested addition of ¶ 12.3 to the Commentary on article 15).

\(^{276}\) Id.
mitigating international double taxation. Although a common set of rules dividing option income between employment compensation and capital gains alleviates some instances of double taxation, it is also necessary to provide rules for allocating or sourcing the option income between the residence and source countries.

c. Allocating and Sourcing Option Income

Along with character, the allocation of income is the most important issue to be resolved to prevent international double taxation. It is, however, difficult to address allocation and character separately, since a country's determination of the source or allocation of income may depend on the income's character. For instance, the United States sources income from property sales, which generally are capital transactions and not subject to multiple sourcing on the basis of residence, whereas employment income is sourced on the basis of the location where the services are performed.277

A key conclusion in the OECD Report is that the employee stock options clearly have a compensatory component that should be treated as compensation under article 15.278 Once the compensatory element is recognized and the time over which it is measured is established, it then becomes possible to address how the income is to be allocated. This step is necessary to determine whether a country has primary, secondary, or any jurisdiction to tax the option income.

The OECD Report recognizes that options may be awarded for past services or as an inducement to render future services, but espouses a clear preference for treating them as being granted for future services.279 The

277. I.R.C. § 865(a) (West Supp. 2003) (sourcing income from personal property sales); id. § 861(a)(3) (sourcing income from compensation); id. § 863(b) (sourcing income from services rendered in more than one country). A very important exception, which probably swallows the general rule of section 865(a) in economic importance, is for inventory purchased within one country and sold without. See id. § 863(b)(2).

278. OECD Report, supra note 17, at ¶ 30, art. 15 cmt. at ¶ 2.1.

279. The OECD Report suggests treating options as granted for past service only if the option grant was conditional on the grantee's past services, for instance, where the grant was "demonstrably based" on the employees past services or the employer's past financial results and the employee was required to be employed during the period covered by the results. Id. at ¶ 30, art. 15 cmt. at ¶ 12.11. In situations where it is ambiguous whether the grant relates to past or future services, the OECD Report opts for future services: "[I]t should be recognized 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." Id. at ¶ 30, art. 15 cmt. at ¶ 12.13. The OECD Report recognizes that there
precise basis upon which options are rewarded, however, is to be determined under the facts and circumstances of the employment arrangement. If two countries do not agree on the source of the option income, i.e., to which period of employment the option income relates, double taxation may be impossible to avoid.

For options granted as an inducement for future services, the OECD Report suggests that option income be allocated over the period from grant until vesting. No option income would be related to services rendered after the employee had performed the services necessary “to acquire the right exercise the option.”\(^{280}\) This approach shortens the period over which option income is to be allocated compared with that in the U.S.-U.K. Treaty and some, but not all, United States administrative guidance.\(^{281}\) If the option is vested, but the shares received would not be, the OECD Report suggests allocating option income over the period from grant until the shares vest.\(^{282}\)

It is not entirely clear why the drafters chose the vesting period as the time over which to allocate option income. Once the options vest, the employee may freely exercise them. Consequently, an employee’s decision to retain, rather than exercise, the options may be similar to a decision to invest in the company. On the other hand, by not exercising the options, the employee is presumably still motivated to work hard to increase the value of the company. Thus, unexercised options arguably still have a compensatory component.

Once the compensatory option income and period to which it should be allocated are determined, the income must be allocated among the states where services have been performed. This is necessary to determine which country has jurisdiction to tax the income. The OECD Report suggests that

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may be instances where the option grant could be shown to be related to both past and future services. \(\textit{Id.}\)

280. \(\textit{Id.}\) at \(\S\) 30, art. 15 cmt. at \(\S\) 12.7.

281. \(\textit{See discussion supra Part V.B.1.}\)

282. OECD Report, \(\textit{supra}\) note 17, at \(\S\) 30, art. 15 cmt. at \(\S\) 12.10. The OECD Report states that the vesting requirement may be relaxed in certain “exceptional cases,” for example, where immediately vested options are awarded but for demonstrably future services, such as beginning employment, being transferred to a new country, or given significant new responsibilities. \(\textit{Id.}\) There is no discussion of how option income should be allocated if it arises in one of these situations, especially since there may be no definitive future period to which the option can be linked or exercise may occur before the termination of the period. For instance, if an option is awarded upon a transfer to a new country for a proposed three-year period, but the option is exercised prior to the termination of the period, should the option income be allocated only to the period during which the person works in the new country until exercise?
option income should be allocated among states where services have been performed on the basis of the number of days services are performed during the relevant period.\textsuperscript{283} This method follows the U.S. approach\textsuperscript{284} and is the most administratively feasible. Given the difficulty in measuring option value for employee stock options, the day count approach is really the only viable method.\textsuperscript{285}

One important issue that is not addressed in the Report is how option income is to be treated for purposes of article 15, paragraph 2 of the OECD Model Treaty, which limits source basis taxation of compensation if it is "paid by, or on behalf of, an employer who is not a resident of the [source] state."\textsuperscript{286} Since it is not uncommon for an employee of a subsidiary to be granted options of a publicly traded parent, the issue arises as to who is treated as paying the compensation when the options are exercised – the parent or the subsidiary. Under U.S. law, when an employee of a subsidiary exercises options granted by the parent, the transaction is treated as a purchase of the stock by the subsidiary for fair market value, with the cash supplied by the parent and employee.\textsuperscript{287} The subsidiary is entitled to deduct the compensation component under section 83(h). For example, if an employee of a parent is sent to work temporarily for a U.S. subsidiary, and exercises options of the parent stock while an employee of the subsidiary, the United States would treat the compensation as being paid by the subsidiary. The country of residence, however, may treat it as paid by the parent, in which case it could not be taxed by the United States.

\textsuperscript{283} id. at \S 32.
\textsuperscript{284} See discussion supra Part V.B.1.
\textsuperscript{285} The earlier discussion draft of the OECD Report left open the possibility of using changes in option value during a particular period, but stated that it should be limited to "exceptional cases" agreed upon by the competent authorities. This was deleted in the revised report. OECD Report, supra note 17, pt. I, at \S 42.
\textsuperscript{286} OECD Model Treaty, supra note 15, at art. 15, \S 2. The OECD Report does, however, recommend amending the commentary to article 15 dealing with remuneration "borne by" a permanent establishment. In particular, the commentary to article 15 would be amended to provide that the fact that stock option remuneration is not deductible by a permanent establishment merely because of the nature of the payment is not conclusive for determining whether the remuneration is borne by the permanent establishment. OECD Report, supra note 17, at \S 61. The proper test is whether "any deduction otherwise available for that remuneration would be allocated to the permanent establishment." Id.
\textsuperscript{287} Treas. Reg. \S 1.1032-3(e) ex.8 (as amended in 1981). Certain conditions must be satisfied to obtain this treatment. See id. \S 1.1032-3(c).
d. Coterminous Residence Basis Taxation

Perhaps the most difficult issue (and the one that may commonly arise) addressed by the OECD Report is the conflict that arises when two or more countries tax option income on a residence basis. As the above examples illustrate, a grantee could be subject to multiple residence basis taxation if she resides in different countries throughout the life of the option, and each countries taxes options on a different basis, e.g., grant, vesting, or exercise. As the OECD Report also notes that the risk of double taxation increases as countries treat change of residence as a taxable event or tax the income of former residents. The OECD Report highlights the issue with an example in which an option grantee performs services in four countries and is taxed on a residence basis in the first and last. The first country taxes options when granted and the last country when exercised. The example assumes that each country will follow a daily allocation principle for the option income, and there are tax treaties between all countries. Both residence countries may tax the entire option benefit, but must grant a credit under article 23 for source basis taxes, even if levied by a country exerting residence basis taxation. In this case, double taxation arises with respect to the portion of the option income that is allocable to the third country, but is taxed by both of the residence countries. The greater the differential between the residence and source country rates, the greater the double taxation.

Example 6

A is granted stock options while a resident of country X in year 1, performs services in country Y in year 2 but is not a resident of Y, and performs services in Z in year 3 and is a resident of Z. X taxes A when the options are granted, Z when the options are exercised, X and Z’s tax rates are 40%, and the option income is $120. X, Y, and Z are all credit countries.

Both X and Z would tax the entire $120. Y could not tax any of the option income, because A is not a resident of Y. X and Z would grant a credit for the foreign taxes paid, but only with respect to the portion of the

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289. OECD Report, supra note 17, at ¶ 38.
290. Id.
291. Id.
292. This is a slightly simplified version of the example found in the OECD Report. Id. at ¶ 43.
income properly allocable to the other residence country and not on the portion of the option income allocable to country Y but taxed by both X and Z. A’s country X pre-credit tax liability would be: $120 x 40% = $48. Under article 23, it would credit the country Z taxes levied on the portion of the option income allocable to Z, $16 ($48 x (40/120)). A’s country Z, pre-credit tax liability would be: $120 x 40% = $48. It would credit the country X taxes levied on the portion of the option income allocable to X, $16 ($48 x (40/120)). A’s total tax liability would be: $64 [$48+$48-$16-$16].293 Thus, the portion of the option income allocated to country Y, $40, would be double taxed by both X and Z. If Y properly taxed the option income so that it was creditable under a treaty with X and Z, there could still be double taxation, but only to the extent that Y’s tax rate was less than X and Z’s.294

To mitigate double taxation that can arise upon the coterminous exertion of residence basis taxation, the OECD Report suggests that a country exerting residence basis taxation could grant relief under the mutually agreed-upon procedure for other residence basis taxes imposed on income that arises while the person was a resident of the other country.295 In the above example, since A was a resident of X while he performed services in Y, Z should grant relief for country X taxes imposed on Y income.

This approach, which is consistent with the general thrust of treaties to favor residence basis taxation over source basis, would relieve the double taxation that arises in the above example. In its exposition of the problem of multiple residence basis taxation, however, the OECD Report fails to specifically address the consequences arising from the fact that the option benefit taxed by each of the residence countries will likely not be the same if both tax on different bases. The OECD Report appears to implicitly assume that the option benefit included in the tax base by both countries will be

293. A slightly different result could occur under U.S. law. Assume that Z is the United States, A is a U.S. citizen, and X would credit U.S. taxes paid pursuant to article 23. A’s U.S. foreign tax credit would be $32, calculated as follows: $80 (foreign source income)/$120 (worldwide income) x $48 pre-credit U.S. tax liability. Thus, A would pay $16 to the United States and $32 to X ($48 - $16), for a total of $48. The difference between the two examples arises because of the mechanism the United States uses to calculate the foreign tax credit. The untaxed country Y income is averaged with the country X income, effectively increasing A’s foreign tax credit.

294. Assume that Y’s tax rate is 20%, and X and Z’s is 40%. A would owe $48 to X, but would receive a credit of $8 for Y taxes and $16 of Z taxes; A would owe $48 to Z, but would receive a credit of $8 for Y taxes and $16 for Z taxes. A’s total taxes paid would be $56 [$48+$48+$8-$16-$16-$8-$8].

295. OECD Report, supra note 17, at ¶ 45, 46 (referring to the suggested addition of ¶ 4.3 to commentary on article 4).
identical. How double taxation should be viewed and relieved is not entirely clear in these more realistic circumstances.

Example 7
A is granted stock options while a resident of country X in year 1 and splits services 50-50 between countries X and Z. X taxes options when granted, and A is taxed on $30 in year 1. In year 2, A becomes a resident of Z, which taxes options when exercised. A exercises the options in year 2 and is taxed on $90. X and Z’s tax rates are 40%.

In year 1, A will have a country X pre-credit tax liability of $12, and in year 2, a country Z liability of $36. It is not clear, however, how to determine the relief each country should grant for the other country’s taxes. This will depend on X and Z’s domestic law and treatment of relief under the X-Z treaty.

Assume, for example, that X is the United States, the options are taxed at grant, and A is a citizen of the United States. A would have a $12 pre-credit U.S. tax liability in year 1. A’s foreign tax credit limitation would be $6, calculated as follows: $15 (foreign source income)/$30 worldwide income x $12 (pre-credit X taxes). Since no foreign taxes were paid in year 1, A would have an excess limitation of $6. A would have a country Z pre-credit tax liability of $36 in year 2, and A’s foreign tax credit limitation would be $18, calculated as follows: $45 (foreign source income)/$90 worldwide income x $36 (pre-credit X taxes).

If both countries agree that the other can properly tax one half of the benefit, since the services were split evenly between the two countries, it is possible that A could carryback foreign taxes of $18 to year 1 and carryforward $6 of foreign taxes to year 2. In that case, A would have a total income of $90 and have total taxes of $36, plus excess foreign tax credits of $12 ($18 less $6 used). The excess credits could be used to offset future low-taxed, foreign source income. Thus, on $90 of income, A pays a total of $36 of taxes, for an effective rate of 40%, but also has a $12 foreign tax credit carryback in country X. If those credits can be eventually used, the total taxes paid by A will be $24 for an effective rate of 26.67%. This is

296. This assumes that X would consider the subsequently rendered services to determine the source of the option income in year 1.

297. $12 of taxes in year 1 less $6 carried back and used from year 2, plus $36 of taxes in year 2 less $6 carried forward from year 1.

298. When the shares are sold, country X may tax the gain. If the gain is treated as foreign source, the excess credits may be used. Also, if A is never again subject to country X.
equivalent to exempting $30 of the option gain from taxes anywhere. The reason this occurs in this example is that X is granting a credit for taxes on income that may never enter its tax base.

Some guidance on this issue from the OECD would be helpful. If the income taxed in Z were taxed again in country X, for example, when the underlying shares are sold, the carryback of the $12 would be proper. If, however, any subsequent income from the shares would not be taxed, it may be appropriate to limit the amount of the carryback.299 This approach may be similar to the "ordinary credit" method of article 23 of the OECD Model Treaty.300 This may be a matter more appropriately addressed in domestic law rather than under a particular treaty.

VII. CONCLUSION

Disparate taxation of compensatory stock options among nations can give rise to international double taxation of peripatetic employees. Double taxation or exemption of option income arises because countries tax the compensatory component of option income at different times and an option holder may be taxed on a residence basis by more than one country. Because many firms believe that granting options to employees helps maximize firm value, it is imperative that solutions be found to avoid double taxation. There are various unilateral and bilateral approaches to mitigate double taxation of peripatetic employees. The United States, for example, should consider amending its domestic foreign tax credit provisions to permit foreign taxes paid by a nonresident to be creditable if the income is later taxed by the United States. All new income tax treaties, like the new U.S-U.K. Treaty, should specifically address the treaty source and character of option income and determine which country has primary or secondary jurisdiction to tax option income. The OECD Report is an important first step in arriving at an international consensus on the proper international tax treatment of option income, but additional clarifications are necessary. Incorporating these conclusions in the commentary to the OECD Model Treaty will provide much needed guidance and provide a framework for related future issues, such as other types of equity-linked deferred compensation.

jurisdiction, the $12 carryback can never be used.

299. Under current U.S. domestic law, the entire amount of foreign taxes paid could be carried back. See supra Part VI.B.

300. See OECD Commentary, supra note 230, at ¶ 16.