The EC Tax Journal

TAXATION OF NON-TRADABLE STOCK OPTIONS GRANTED TO EMPLOYEES BEFORE SECONDMENT: A GERMAN POINT OF VIEW

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The tax treatment of non-tradable stock options has come more and more into focus now that it is commonly considered that tradable stock options are subject to German income tax as at the date when they are granted. In this context, international cases give rise to some special problems.

This article tries to solve at least one of them. The question is what, from a German point of view, will happen if an employee is granted stock options whilst resident outside Germany and exercises the options whilst resident in Germany and employed by a German entity related to the foreign grantor.

National Tax Law

Basically, under German national tax law, the answer to the question of whether individuals who leave one jurisdiction and exercise their options whilst resident in another jurisdiction will be taxed on exercise of their options depends on two facts: the possibility of trading the options and the personal situation of the employees before the options were granted.[2]

In Germany, the benefit of an option to an employee, calculated as the difference between the fair market value of the shares on the day of the transfer to the employee

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2 FG Köln, Judgment of 09.09.1998,- 11K 5153/97, DStR 1999, 368 (370 et seq).

and the exercise price, as defined by the underlying regulations,[3] will be taxed on the day of the exercise of the options if the options are not tradable.[4] They have to be strictly personal to the holder and may, therefore, not be customary in the market.[5] Otherwise, the benefit represented by the options is taxed as employment income received on the day when they are granted.

Although non-tradable options bear tax consequences at the date of exercise, the requirements which must be met so as to give rise to the right to tax the corresponding benefit have to be satisfied on the day the options are granted.[6] It is not the time when employment income is received but rather the reason for the receipt which is decisive for tax purposes.[7] Therefore, the granting of the options is seen as income paid for preceding employment.[8]

This approach may accord with the facts in many cases, but in some cases options are granted just because the employer intends to increase the motivation of a new employee or to strengthen his ties with the company. In my view, a different tax treatment should apply in these cases.

Furthermore, it is not important whether the employer or a third person grants the options as long as the benefit is referable to the employment.[9] Accordingly, it will not make any difference if stock options are granted to an employee of a German subsidiary by its parent company resident outside Germany.

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3 BFH, Judgment of 21.03.1975 - VIR 55/73 BStBl. II 1975, 690 (393); FG Köln, Judgment of 09.09.1998, loc. cit.

4 See BFH, Judgment of 10.03.1972 - VI R 278/68, BStBl. II 1972, 596 (597); Judgment of 21.03.1975 - VI R 55/73, BStBl. II 1975, 690 (692); Judgment of 08.08.1991 - VI B 109/90, BStBl. II 1991, 929 (929); FG Köln, Judgment of 09.09.1998, loc. cit., 370; Herzig, DB 1999, p. 1 (4).

5 OFD Berlin, direction of 25.03.1999 - St 423 - S 2347 - 1/99; Income Tax Court-Index Berlin, division 1 no. 808.

6 BFH, Judgment of 18.07.1973 - I R 52/69, BStBl. II 1973, 757 (758); Judgment of 05.02.1992 - I R 158/90, BStBl. II 1992, 660 (660); see: Portner, DStR 1998, p. 1535 (1537).

7 BFH, Judgment of 27.01.1972 - I R 37/70, BStBl. II 1972, 459 (460).

8 BFH, Judgment of 21.03.1975 - VI R 55/73, BStBl. II 1975, 690 (691); FG Köln, Judgment of 09.09.1998, loc. cit., 369; different opinion: Portner, DStR 1997, p. 786 (788).

9 BFH, Judgment of 10.03.1972 - VI R 278/68, BStBl. II 1972, 596 (597); FG Köln, Judgment of 09.09.1998, loc. cit.

Finally, it has to be noted that, if Germany has the right to tax a benefit on the day of the exercise of the options, a reduced tax rate will be applicable according to Section 34 paras. 1,2 No. 4 Income Tax Act.[10] The employee has to apply for this special tax rate. It is granted because the grant of the option is seen as income for several years.

Recent Developments

At the moment, a change in the tax treatment of non-tradable stock options in Germany seems to be unlikely, although two appeals lodged against judgments by the Fiscal Court of Cologne are still pending at the Federal Fiscal Court.[11] So far, the court has always been of the opinion that stock options are taxed at the date of exercise,[12] irrespective of strong criticism in literature[13] and the different legal situation in other European countries.[14]

In its decision of 23rd July 1999,[15] the Federal Fiscal Court held that the taxation of non-tradable stock options on the day of exercise is not seriously to be doubted and does not therefore, justify the stay of execution of a tax assessment. The main reason pointed out by the Court was that it was not the existence of a claim but the afflux of the remuneration to the employee that was decisive according to section 38 para. 2 sentence 2 Income Tax Act.

10 BFH, Judgment of 21.03.1975 - VI R 55/73, BStBl. II 1975, 690 (692); FG Köln, Judgment of 09.09.1998, loc. cit., 371; Herzig, DB 1999, p. 1 (5).

11 Az. des BFH: I R 100/98; I R 119/98.

12 BFH, Judgment of 10.03.1972 - VI R 278/68, BStBl. II 1972, 596 (597); Judgment of 21.03.1975 - VI R 55/73, BStBl. II 1975, 690 (692); Judgment of 08.08.1991 - VI B 109/90, BStBl. II 1991, 929 (929).

13 Rönitz, JbFfStR 1980/1981, p.. 38 (53); Fasold, DB 1983, p. 809; Döllerer, AG 1986, p. 237 (243); Pelzer, AG 1996, p. 307 (314 et seq); Portner, DStR 1997, p. 1876 (1878); Isensee, DStR 1999, p. 143 (145); Bredow, DStR 1999, p. 371 (372); Schubert, FR 1999, p. 639 (645).

14 See: Portner, DStR 1998, p. 1535 (1536 et seq).

15 VIB 116/99, DB 1999, 1932.

Furthermore, the Fiscal Court of Rhineland-Palatinate[16] confirmed the opinion of the fiscal court of Cologne in its above mentioned judgments.[17] Both courts uphold the permanent jurisdiction of the Federal Fiscal Court but underline that non-tradable stock options are a mere chance which are impossible to value prior to the day of exercise.[18]

Tax Treaties

The legal situation remains unchanged under the tax treaties as long as they - like e.g. the one between Germany and Great Britain[19] - correspond to Art. 15 of the OECD Model Convention (OECD MC).

Under the OECD Model Convention, it makes no difference when and where income is paid as long as it is paid with reference to employment.[20] According to Art. 15 para. 1, 2 OECD MC, the right to tax employment income is allocated in compliance with the place-of-work principle, but only if the employee is present in the State of employment for more than 183 days in a period of twelve months, and the remuneration is paid by, or on behalf of, an employer in that State or borne by a permanent establishment or a fixed base of the employer in that State.

Thus, if income is referable to work performed in one State, as well as to work performed in another Treaty State, the income should be apportioned according to the relationship between the periods spent in the respective States. The taxation of the employees should depend on their liability to income tax on income from employment in the years before the stock options were granted.

However, the prevailing opinion in legal literature would apportion income according to the relationship between the number of days on which the employee performed

16 FG Rhineland-Palatinate, Judgment of 07.06.1999 - 2 K 3337/98, not yet published in a printed version.

17 FG Köln, Judgment of 09.09.1998, loc. cit., 370; Judgment of 21.10.1998 - 11 K 1662/97, EFG 1999, 116 (116).

18 FG Köln, Judgment of 09.09.1998, loc. cit., 370; of the same opinion: BFH, Judgment of 10.03.1972 - VI R 278/68, BStBl. II 1972, 596 (597); OFD Berlin, direction of 25.03.1999 - St 423 - S2347 - 1/99 -, Income Tax Court Index Berlin, division 1 no. 808.

19 See Art. XI para 2.3.

20 BFH, Judgment of 05.02.1992 - I R 158/90, BStBl. II 1992, 660 (661); FG Köln, Judgment of 09.09.1998, loc. cit., 370; Prokisch in Vogel DBA Art. 15 marginal note 15.

activities abroad and the workdays when he or she was physically present in Germany before the options were granted.[21] In my view, this approach differs from the division of employment income for income tax purposes pursuant to Art. 15 OECD MC.

Although the international allocation of the taxation in connection with stock options seems to be clear according to the prevailing opinion, there remains a risk of double taxation because of the different tax treatments in certain jurisdictions.[22] For example, if a country taxes the benefits resulting from stock options according to the employment situation of the employee on the day of the exercise of the options, the benefit may also be taxed in Germany because of the employee's situation on the day the option was granted.

More important for international tax planning is the fact that the differing tax treatments could offer the opportunity to avoid the taxation of the benefit.

Examples

The current taxation of stock options in Germany in situations, where there is a change of residence between the day of the grant and the day of the exercise of the options, can be illustrated by the following three examples:

(a) Employees are granted options whilst resident and employed outside Germany. They have been employed by the parent company in that country since commencing work. They are then transferred or seconded to a subsidiary in Germany.

In this case, the income resulting from the exercise of the options will basically not be taxed in Germany.

(b) Employees are granted options whilst resident in Germany and working for the German subsidiary of a non-German company. They have been working in Germany since commencing work. They are then transferred or seconded

21 See BFH, Judgment of 18.07.1973 - I R 52/69, BStBl. II 1973, 757 (758); Judgment of 05.02.1992 - I R 158/90, BStBl. II 1992, 660 (660 et seq); Hessisches FG, Urteil v 26.10.1990 - 2 K 2052/86, EFG 1991, 730 (731); Flipsen/Pötgens, ET 1999, p. 321 (323); Herzig, DB 1999, p. 1 (5); Prokisch in Vogel DBA Art. 15 marginal note 15; Schaumburg, International Tax Law, 1998, p. 992 et seq.

22 Portner, DStR 1998, p. 1536 (1537); Herzig, DB 1999, p. 1 (5).

to an entity abroad where the options are exercised.

The benefit resulting from the exercise will be taxable in Germany although the employee will not actually be liable to tax in Germany upon receipt of such benefits.

(c) Employees are granted options whilst employed by the parent company outside Germany, having previously spent some years resident in Germany as an employee of the German subsidiary. On the day when the options are exercised, they are employed by the German entity again and resident in Germany.

In this case, the tax consequences will be different. According to the prevailing view,[23] the benefit resulting from the exercise of the options has to be apportioned according to the relationship between the number of days on which the employee performed activities outside Germany and the number of workdays when he or she was physically present in Germany before the options were granted. In my view, national taxation should take into account the allotment of tax claims by the relevant tax treaties in the fiscal years before the grant of the options.[24]

Conclusion

Non-tradable stock options have become more desirable in Germany because - in contrast to tradable options – they can be and are used to increase the motivation of employees and strengthen the ties between them and the employer. In spite of this development, the taxation of non-tradable stock-options in Germany according to recent court decisions still depends upon the personal situation of the employee before the options were granted. This is the case even if the employee is seconded to a non-German entity of the same concern from the day when the options are granted to the day when they are exercised and taxed in Germany.

It remains to be seen whether the tax treatment of tradable stock options will be subject to change if there are cases where options are granted at the beginning of an

23 BFH, Judgment of 18.07.1973 - I R 52/69, BStBl. II 1973, 757 (758); Judgment of 05.02.1992 - I R 158/90, BStBl. II 1992, 660 (660 et seq); Hessisches FG, Urteil . 26.10.1990 - 2 K 2052/86, EFG 1991, 730 (731); Flipsen/Pötgens, ET 1999, p. 321 (323); Herzig, DB 1999, p. 1 (5); Prokisch in Vogel DBA Art. 15 marginal note 15; Schaumburg, International Tax Law, 1998, p. 992 et seq .

24 See above 2.

employment and, therefore, clearly cannot be seen as income paid for preceding employment.