



Internal Revenue Service

DEPARTMENT OF THE TREASURY

LB&I Concept Unit

Unit Name	Sourcing of Multi-Year Compensation Arrangements Including Stock Options for FTC Limitation	
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General Overview

Sourcing of Multi-Year Compensation Arrangements Including Stock Options for FTC Limitation

Note: This Practice Unit updates the 9/2/2016, Practice Unit with the same title. The update provides some clarifying narrative as well as removing items of reference which are obsolete and removed.

International business is evolving toward a single global marketplace that transcends national borders. With today's proliferation of the global workforce, it is common practice for a company to engage employees to work in foreign locations. Companies that transfer employees outside their home country typically provide additional compensation to supplement base salary in the form of multi-year compensation arrangements that may include various equity-based arrangements such as stock options, certain incentives upon returning to the U.S. and other forms of bonus arrangements. This additional compensation is intended to provide the employee with performance-based compensation.

An essential step in computing the foreign tax credit (FTC) limitation is determining the source of income. The general rule applicable to employees is that the source of compensation received for services is based on where the services were performed on a time basis, but several exceptions apply. Compensation received as an employee in the form of multi-year compensation arrangements, including stock options, is also typically sourced on a time basis, as will be discussed in the detailed explanation.

This Practice Unit provides an overview for the sourcing of multi-year compensation arrangements, including stock options, for the purpose of computing the FTC limitation. This Practice Unit also provides a brief explanation of how equity-based compensation, such as statutory stock options and non-statutory stock options, is taxed.

General Overview (cont'd)

Sourcing of Multi-Year Compensation Arrangements Including Stock Options for FTC Limitation

Sourcing for multi-year compensation arrangements, including certain stock options, can apply to U.S. citizens, resident aliens and nonresident aliens.

U.S Citizens and Resident Aliens:

- U.S. citizens and resident aliens are taxed on worldwide income and may be subject to taxation by the U.S. and a foreign country. In order to mitigate double taxation, U.S. citizens and resident aliens may be eligible to claim FTC for taxes paid to the foreign country.

Nonresident Aliens:

- Nonresident aliens are usually subject to U.S. income tax on only U.S. source income. In limited circumstances, certain foreign source income is subject to U.S. tax. Although uncommon, nonresident aliens who are subject to double taxation may be eligible to claim FTC for taxes paid to a foreign country.

General Overview (cont'd)

Sourcing of Multi-Year Compensation Arrangements Including Stock Options for FTC Limitation

An individual must first assign each item of gross income to a separate category of income before figuring their taxable income from sources outside the U.S. Compensation, including multi-year compensation arrangements and various equity-based stock option plans, is typically included in general category income. However, statutory stock option income that results in capital gain treatment is typically included in the passive category income. If a taxpayer's income is resourced pursuant to a tax treaty, it will be assigned to a separate treaty category. See IRC 904(d)(6) and (h)(1), and Treas. Reg. 1.904-4(m) and 1.904-5(m)(7).

 **CAUTION:** Statutory stock option income that is treated as capital gain is not compensation and is sourced under a different rule, as discussed in the detailed explanation.

 **TREATY IMPLICATION:** Generally, for FTC purposes, a taxpayer who takes a treaty-based return position must disclose that position. A taxpayer takes a treaty-based return position by maintaining that a treaty of the U.S. overrules or modifies a provision of the IRC and thereby causes (or potentially causes) a reduction of tax on the taxpayer's tax return. The taxpayer may be required to file Form 8833, Treaty-Based Return Position Disclosure Under IRC 6114 or 7701(b).

Facts of Concept

Sourcing of Multi-Year Compensation Arrangements Including Stock Options for FTC Limitation

Facts of Concept

A multi-year compensation arrangement is one in which an individual receives compensation in one tax year attributable to services performed in two or more tax years. Services may be performed during the multi-year period both within the U.S. and without the U.S.

One type of multi-year compensation arrangement is an employee bonus plan, in which the individual receives additional compensation to supplement base salary. Additional compensation can also be in the form of stock options. This Practice Unit's focus is on sourcing of multi-year compensation arrangements for the purpose of computing the FTC limitation on Form 1116, Foreign Tax Credit and briefly discusses the basic concepts for stock options. A detailed discussion of the taxation of stock options and the criteria used to determine when income from the exercise of stock options is includable in an individual's taxable income is outside the scope of this Practice Unit.

 **CAUTION:** Many individuals working overseas will not have a U.S. tax document that states the amount of gross income they received for the year. As part of examining a Form 1040 of an individual who is a U.S. citizen or resident who earns foreign source income, consideration should be given to whether the individual reported all their worldwide income from all sources.

Detailed Explanation of the Concept

Sourcing of Multi-Year Compensation Arrangements Including Stock Options for FTC Limitation

How are statutory stock options and multi-year compensation arrangements sourced?

Analysis	Resources
Individuals must determine whether gross income in each separate category is U.S. source or foreign source income. Typically, the source of multi-year compensation, including stock options, is determined on a time basis over the period to which the compensation is attributable. Generally, the total compensation is apportioned between U.S. and foreign sources based on the relative days worked in the U.S. and outside the U.S. This time-based sourcing rules applies only to compensation. If compensation, the income will be taxed at ordinary rates. Sourcing for statutory and non-statutory stock option compensation income is generally apportioned between U.S. source and foreign source based on relative days worked in the U.S. and outside the U.S. during the period between the grant date and the date the stock options become exercisable (vesting date).	▪ IRC 865, Source rules for personal property sales ▪ Treas. Reg. 1.861-4(b)(2)(ii)(F), Compensation for labor or personal services performed partly within and partly without the U.S. ▪ CCA 201438027 – IRC 904(c)

Detailed Explanation of the Concept (cont'd)

Sourcing of Multi-Year Compensation Arrangements Including Stock Options for FTC Limitation

How are statutory stock options and multi-year compensation arrangements sourced?

Analysis	Resources
The period to which the compensation is attributable is based on the facts and circumstances of each case. For example, the amount of compensation that specifically relates to a period of time that includes several calendar years is attributable to the entire multi-year period. Formula for Determining Foreign Source Compensation on a Time Basis: $\text{Compensation X } \frac{\text{Total Days Services Were Performed Outside the U.S. During the Period}}{\text{Total Days Services Were Performed Both Within and Without the U.S. During the Period}}$ Note: Because different types of compensation may relate to services performed during different time periods, this formula may have to be applied to each type of compensation separately.	▪ IRC 865, Source rules for personal property sales ▪ Treas. Reg. 1.861-4(b)(2)(ii)(F), Compensation for labor or personal services performed partly within and partly without the U.S.

Detailed Explanation of the Concept (cont'd)

Sourcing of Multi-Year Compensation Arrangements Including Stock Options for FTC Limitation

How are statutory stock options and multi-year compensation arrangements sourced?

Analysis	Resources
<u>Alternative Basis, Exception and Special Rules:</u> ▪ The Commissioner also may determine, under the facts and circumstances of the particular case, the source of compensation that is received by a taxpayer as an employee for services performed partly within and partly without the U.S. The Commissioner can make a determination other than on a time basis as defined in the regulations, only if such alternative basis is a more reasonable method than the method used by the taxpayer. ▪ Self-employed individuals determine the source of compensation for labor or personal services from self-employment based on the relevant facts and circumstances that most accurately reflects the proper source of the income. Time basis may be acceptable if supported by the facts and circumstances.	▪ Treas. Reg. 1.861-4(b)(2)(ii)(C)(1)

Detailed Explanation of the Concept (cont'd)

Sourcing of Multi-Year Compensation Arrangements Including Stock Options for FTC Limitation

How are statutory stock options and multi-year compensation arrangements sourced?

Analysis	Resources
<u>Alternative Basis, Exception and Special Rules (cont'd):</u> ▪ If the taxpayer is an employee, the taxpayer can determine the source of compensation under a basis other than a time basis if the taxpayer can establish to the satisfaction of the IRS that, under the facts and circumstances of that particular case, the alternative basis more properly determines the source of taxpayer's compensation than the time basis. If the taxpayer uses an alternative basis, the taxpayer must keep (and have available for inspection) records to document why the alternative basis more properly determines the source of the taxpayer's compensation. Also, if the taxpayer's total compensation from all sources was \$250,000 or more, the taxpayer must check the box on Form 1116, line 1b, and attach a written statement to the taxpayer's tax return with various taxpayer personal information and the relevant method of allocation identified and the computations, along with a comparison to the time basis of apportionment.	▪ Treas. Reg. 1.861-4(b)(2)(ii)(C)(1)

Detailed Explanation of the Concept (cont'd)

Sourcing of Multi-Year Compensation Arrangements Including Stock Options for FTC Limitation

What are the general rules for taxing stock options?

Analysis	Resources
Individuals that receive an option to buy or sell stock or other property as payment for services may have income: ▪ When they receive the option (the grant date), ▪ When they exercise the option to buy the stock or other property (the exercise date) or ▪ When they sell or otherwise dispose of the option or property acquired through exercise of the option (the sale date). The timing, type and amount of income inclusion depends on whether the option was a statutory stock option or a non-statutory stock option. A statutory stock option is one that is granted under an employee stock purchase plan (ESPP) or an incentive stock option (ISO) plan. A non-statutory stock option is one that is not granted under either an ESPP or an ISO plan.	▪ IRC 83, Property transferred in connection with performance of services ▪ IRC 421-424, General rules, effect of qualifying transfer and stock options ▪ Pub. 525, Taxable and Non-taxable Income

Detailed Explanation of the Concept (cont'd)

Sourcing of Multi-Year Compensation Arrangements Including Stock Options for FTC Limitation

What are the general rules for taxing stock options?

Analysis	Resources
For statutory options, the individual must be an employee of the company granting the options. There are specific employment and non-transferability rules that apply. The individual does not include any amount in income on either the grant or exercise dates of a statutory stock option, except for Alternative Minimum Tax (AMT) on exercise. The taxable gain or loss is reported on the individual's tax return when the stock acquired is sold. If certain holding period requirements are met, the gain or loss from the sale of the stock is generally a capital gain or loss. This capital gain or loss will not be considered compensation. If the holding period requirements are not met, all or part of the gain may be treated as compensation and taxed at ordinary income rates. A non-statutory stock option is taxed when it is granted if the option has a readily ascertainable Fair Market Value (FMV) at that time. A non-statutory stock option without a readily ascertainable FMV is taxed when it is exercised. The FMV of an option can be readily determined if it is actively traded on an established market. In both cases, the income is compensation and taxed at ordinary income rates. Any gain or loss realized upon the disposition of the stock is treated as capital gain or loss and is not compensation. An in-depth discussion of the taxability of stock options is beyond the scope of this Practice Unit. See Pub. 525, Taxable and Non-taxable Income, for more detailed information regarding the gain or loss on these types of transactions.	▪ IRC 83, Property transferred in connection with performance of services ▪ IRC 421-424, General rules, effect of qualifying transfer and stock options ▪ Treas. Reg. 1.83-7(a), Taxation of nonqualified stock options ▪ Pub. 525, Taxable and Non-taxable Income

Detailed Explanation of the Concept (cont'd)

Sourcing of Multi-Year Compensation Arrangements Including Stock Options for FTC Limitation

How are statutory and non-statutory stock options taxed?

Analysis	Resources
Capital gains on the disposition of stock options are considered unearned (passive category) income. Compensation income from stock options is considered earned (general category) income. Any part of the earned income that is due to work the individual performed in a foreign country(s) is considered foreign source earned income which would be included in the computation of the earned income exclusion per IRC 911. Because capital gains on the disposition of stock options or stock are not considered compensation, they are not sourced according to the time-based method described in this Practice Unit. Instead, they are sourced according to the residence of the seller.	▪ IRC 83, Property transferred in connection with performance of services ▪ IRC 421-424, General rules, effect of qualifying transfer and stock options ▪ IRC 911, Earned Income Exclusion ▪ Pub. 525, Taxable and Nontaxable Income

Examples of the Concept

Sourcing of Multi-Year Compensation Arrangements Including Stock Options for FTC Limitation

Example

On 1/1/2016, an employee received a grant of 100 non-statutory stock options from their U.S. company employer to purchase the company's stock for \$5 per share. The options did not have a readily ascertainable FMV at the grant date. The options become exercisable if the individual works for the company for a 5-year period. Under the regulations, the services performed by the employee after the date the stock options become exercisable (in other words, vested) are not taken into account in sourcing the compensation from the stock options. The individual performed the services for the company within the U.S. for 3.5 years (1/1/2016 – 6/30/2019) and in the foreign country for 1.5 years (7/1/2019 – 12/31/2020) during the 5-year period.

On 12/31/2022, the individual exercised the options to buy the stock; the FMV of the stock at the time of exercise was \$10 per share. The individual has \$500 of taxable compensation which is taxed as ordinary income. Pursuant to IRC 861 and Treas. Reg. 1.861-4 (b)(2)(ii)(A), the individual sources the income between the U.S. and the foreign country based on time.

Exercise value (\$10 x 100 shares)	\$1,000
Purchase Price (\$5 x 100 shares)	<u>500</u>
Compensation	<u>\$ 500</u>
U.S. Source (3.5yrs/5yrs x \$500)	\$ 350
Foreign Source (1.5yrs/5yrs x \$500).....	\$ 150

Index of Referenced Resources

Sourcing of Multi-Year Compensation Arrangements Including Stock Options for FTC Limitation	
IRC 83	
IRC 421 - 424	
IRC 861	
IRC 865	
IRC 904(c)	
IRC 904(d)(6)	
IRC 904(h)(1)	
IRC 911	
IRC 6114	
IRC 7701(b)	
Treas. Reg. 1.83-7(a)	
Treas. Reg. 1.861-4 (b)(2)(ii)(A)	
Treas. Reg. 1.861-4(b)(2)(ii)(C)(1)	
Treas. Reg. 1.861-4(b)(2)(ii)(F)	
Treas. Reg. 1.904-4(m)	
Treas. Reg. 1.904-5(m)(7)	

Index of Referenced Resources (cont'd)

Sourcing of Multi-Year Compensation Arrangements Including Stock Options for FTC Limitation
CCA 201438027
Publication 525

Training and Additional Resources

Sourcing of Multi-Year Compensation Arrangements Including Stock Options for FTC Limitation	
Type of Resource	Descriptions
Job Aid	▪ FTC Workbook - used to assist agents in computing FTC limitation for Form 1116. The FTC Workbook is available under Foreign Tax Credit Resources in the Foreign Tax Credits Individual book in the International Knowledge Base of the IRS Virtual Library.
Databases / Research Tools	▪ BNA Tax Management U.S. International Portfolios 6000-1st – Essential Elements of U.S. International Taxation, Source of Income, Source of Compensation for Personal Services

Glossary of Terms and Acronyms

Term/Acronym	Definition
AMT	Alternative Minimum Tax
ESPP	Employee Stock Purchase Plan
FMV	Fair Market Value
FTC	Foreign Tax Credit
ISO	Incentive Stock Option

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
9432	Sourcing of Fringe Benefits for FTC Limitation
9432	Sourcing of Salary and Compensation