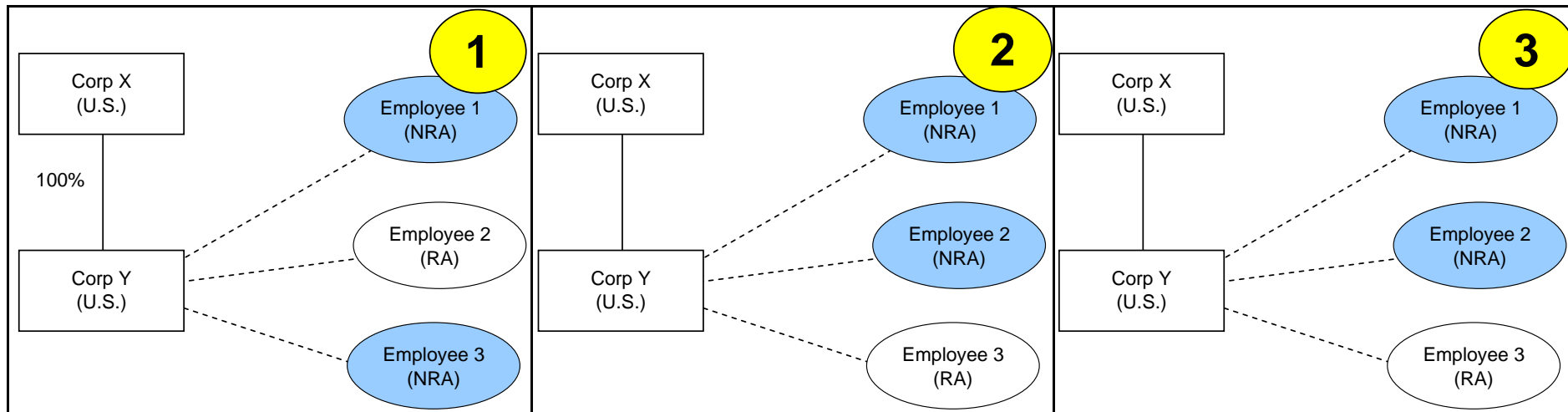


**Taxation of Stock Options
Granted to NRAs**

Grant

Vest

Exercise



Corp X is a State B corporation engaged in business A. Corp Y is also a State B corporation whose business is the international marketing of Corp X products. Corp Y is a wholly-owned subsidiary of Corp X and is included in the consolidated federal income tax return filed by Corp X. Corp Y conducts its business on a worldwide basis and has employees in a number of foreign countries.

Corp X maintains a restricted stock compensation plan the purpose of which is to attract, retain and motivate key employees. Under this plan certain key employees are awarded stock that is subject to a substantial risk of forfeiture. The main provision of this plan provides that stock issued under the plan vests in the employee upon the earlier of retirement or 5 years lapsing from the date of the award of such stock (the vesting period). In addition, stock received under the plan may not be sold or transferred by the grantee during the vesting period. If the grantee's employment with the corporation terminates prior to the end of the five year vesting period for any reason other than retirement, death or disability, without the consent of the Corp X Stock Option and Compensation Committee, all restricted stock held by the grantee shall be forfeited. Stock awarded under this plan is intended to be compensation for services to be rendered by such key employee during the vesting period.

Certain employees of Corp Y receive shares of restricted stock pursuant to the Corp X restricted stock plan. These employees have not elected to be taxed on the stock at the date of issuance under section 83(b). Some Corp Y employees that receive stock under the plan are nonresident aliens during part of the vesting period. These employees fall into three different groups: first, those who are nonresident aliens for the entire vesting period (such as Employee 1); second, those who are resident aliens at the time of the award but subsequently become nonresident aliens and are still nonresident aliens at the end of the vesting period (such as Employee 2); and third, those who are nonresident aliens at the date of the award but subsequently become resident aliens and are still residents at the end of the vesting period (such as Employee 3).

The nonresident alien employees of Corp Y are neither citizens or residents of any country that has an income tax treaty with the United States. The issue presented was whether income received by nonresident aliens under Corp X's restricted stock plan is from sources within the United States and, as a result, is subject to the withholding of tax pursuant to section 1441(a). Compensation for labor or personal services performed in the United States is generally treated as income from sources within the United States while compensation for labor or personal services performed outside the United States is treated as income from

sources without the United States (sections 861(a)(3) and 862(a)(3)).

For the tax years beginning after December 31, 1986, the Tax Reform Act of 1986 amends section 864 to provide that any income of a nonresident alien for any taxable year that is attributable to the performance of services in any other taxable year shall be treated as effectively connected with the conduct of a trade or business within the United States if it would have been so treated if such income were taken into account in such other taxable year (section 864(c)(6)).

Section 83 governs the timing of the inclusion in income of compensation with respect to stock issued under the Corp X restricted stock plan. Under section 83 , an individual will not include compensation income with respect to property received in connection with the performance of services until the property is substantially vested, i.e., the property is transferable or is not subject to a substantial risk of forfeiture. Until the property becomes substantially vested, the transferor will be considered to be the owner of the property and any income from the property received by the employee is to be included in the employee's income as additional compensation in the year of receipt Reg. 1.83-1(a). Section 83(b) gives the recipient of such property the right to elect to include in income the value of the property (minus the amount paid for the property) in the year of transfer. As noted above, the employees of Corp Y in question have not made a section 83(b) election. Therefore, compensation income with respect to the Corp X stock is measured and included in income as of the date the Corp X stock is substantially vested.

If an employee is a resident on the date of substantial vesting, the employee is taxed on all of the income as if the employee were a United States citizen.

For taxable years beginning after December 31, 1986, if the employee is a nonresident alien on the date of substantial vesting, the income will be treated as effectively connected income if it would have been treated as effectively connected if taken into account in the year or years in which the services giving rise to the income were performed.

Both the amount of effectively connected income and the amount of United States source income depend upon where the services giving rise to the income were performed. Because the grant of the stock is not, itself, compensation and the restrictions on the Corp X stock merely relate to the passage of time after the grant, the services giving rise to the income are the services performed during the entire period of the restriction. Therefore, the place or places where the services were performed during the entire period of the restriction will determine the amount of effectively connected income and the source of the income.

For tax years beginning after December 31, 1986, if an employee of Corp Y who received stock under the Corp X restricted stock plan was a nonresident alien at the time such stock became substantially vested and performed services in the United States during the vesting period, subject to the de minimis rule, the employee will have compensation income from United States sources that will be subject to tax under section 871(b) in the amount that bears the same relation to the total amount of compensation includable in income because of the substantial vesting under the principles of section 83 (in general, the fair market value of the stock on the date it became substantially vested minus the amount paid (if any) for such stock) as the amount of time that services were performed in the United States during the time period that the Corp X stock was not substantially vested bears to the total time period during which services were performed and the stock was not substantially vested. (section 864(c)(6)).

De minimis rule: If, for any taxable year, the compensation income that is attributable to the taxable year does not, when added to other income for the performance of services in the United States for that year, exceed \$3,000, and if the nonresident alien employee was temporarily present in the United States for a period not exceeding a total of 90 days during the taxable year, then the income will not be considered to be income from sources within the United States or from the conduct of a trade or business within the United States and will not be subject to withholding under section 1441 provided that such services are performed as an employee of or under contract with a nonresident alien, foreign partnership, or foreign corporation, not engaged in a trade or business in the United States or an individual who is a citizen or resident of the United States, a domestic partnership, or a domestic corporation, if such service is performed for an office or place of business in a foreign country or in a possession of the United States by such individual, partnership or corporation (sections 861(a)(3) , 864(b)(1) and 1441(a)).

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