KPMG

GMS Flash Alert

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Germany – Landmark Ruling on Stock Option Taxation Adapted to Finance Ministry Circular

The German Ministry of Finance issued a circular on 12 December 2023 and, with respect to all open cases, has confirmed application of the Federal Fiscal Court (*Bundesfinanzhof* - BFH)[1] ruling of 21 December 2022, on residence and the taxation of stock options.

In its decision the BFH commented in detail on the taxation of stock options in the event of a change of residence.

WHY THIS MATTERS

The fact that the decision has now been included in the circular[2] of the German Ministry of Finance (*Bundesministerium der Finanzen* – BMF) as of 12 December 2023, shows its fundamental importance for the tax authorities and requires employers to act accordingly.

What has been made clear is that residency at the time of taxation is decisive for the determination and allocation of the right to tax. This has, moreover, an effect on all kinds of subsequent remuneration components in a cross-border context.

General Rules for the Taxation of Benefits-in-Kind from Stock Options

The actual exercise of stock options results in a benefit-in-kind if shares are transferred free of charge or at a reduced price. The benefit-in-kind is calculated from the difference between the market value of the shares at the time of transfer of the economic ownership and any payment made by the employee (i.e., the acquisition costs).

Once the amount of the benefit-in-kind has been determined, it must be examined whether it should be sourced over the vesting period. In general, the relevant vesting period according to German tax guidance is the period between the grant of the option and the first possible exercise of the option right by the employee ("vesting"). If no direct allocation of domestic and foreign activities is possible, the right of taxation is based on the actual working days in this period irrespective of any change in the employee's resident status during the vesting period.

Key Points of the BFH Ruling

- The benefit-in-kind from the exercise of stock options must be taxed at the time of receipt.
- The benefit-in-kind from the exercise of stock options is earned over time and must therefore be allocated proportionately to the vesting period.
- It is generally justified to regard the vesting period as the period between the granting of the stock options and their initial exercisability.
- Any exemption under tax treaty law in cross-border situations must be based on the activity in the vesting period.
- Insofar as the employment income article of a tax treaty refers to a "resident of a contracting state," only the residence at the time the income is received is decisive.

Why Is This Decision Important for Employers and Wage Tax Withholding?

With this decision, the BFH explicitly clarifies for the first time – in contrast to previous case law – that the individual's residency at the time of taxation is decisive for the determination and allocation of the right to tax. The ruling therefore not only affects the allocation and assignment of the right to tax benefits-in-kind from the granting of stock options but is also transferable to the assessment of all other subsequent remuneration components in a cross-border context (e.g., bonus payments).

Example: Payment of Bonus for the Previous Year

B is employed and resident in the U.S. (the salary is borne in the U.S.). In year 01, she works 150 days in the U.S., 50 days in Germany and 30 days in third countries. Apart from the 80 working days abroad, B only spends time in the U.S. in 01. After checking all relevant double tax treaties (DTTs), the U.S. is entitled to tax B's entire salary in 01.

At the beginning of the year 02, B is assigned for five years to an affiliated company of her U.S. employer in Germany. Her (economic) employer is in Germany during this period. B gives up her residence in the United States for the duration of the assignment. In year 02, B receives the bonus relating to the previous year 01 (performance period).

In accordance with the principle of the above-mentioned decision of the BFH, a total bonus component of 80/230 is taxable in Germany, unless there is a right to taxation under a double taxation agreement with the relevant third country. A review is required as to whether the German employer must withhold wage tax on this portion of the bonus as part of the German payroll. In accordance with BFH case law, the bonus portion of 150/230 attributable to the U.S. working days is not taxable in Germany (subject to progression).

As a result of the recent BFH decision and the relevance of residency at the time of taxation, the tax base in Germany has increased significantly in this example. In the opposite case, however, the tax base would be reduced, as the right of taxation for U.S. and third-country working days would then be allocated to the United States.

Necessary Steps for German Employers

For domestic employers, the BFH ruling means that they have to make sure that subsequent payments are correctly assessed for income tax purposes, therefore:

- travel calendars covering the vesting period of the respective remuneration must be evaluated and taken into account;
- all relevant information relating to the vesting period must be evaluated and taken into account – this applies in particular to the plan conditions (for example, the question of whether or not the stock options expire when the employer changes, etc.);
- it is necessary to determine the employee's residency according to the DTT at the time of receipt.

KPMG INSIGHTS

The BFH decision may lead to an increased risk of double taxation, particularly in German inbound cases. This occurs if the foreign country's residence in the vesting period is decisive and – if the conditions are fulfilled – the remuneration is taxed in full at the time of receipt. This requires coordination with the foreign country and, if necessary, with the German tax authorities.

FOOTNOTES:

1 See Bundesfinanzhof verdict of 21 December 2022, case Az. I R 11/20. *Urteil vom 21. Dezember 2022, I R 11/20: Zur Besteuerung von Stock Options im Fall des Ansässigkeitswechsels*.

2 See Bundesministerium circular of 12 December 2023, *Az. IV B 2 – S 1300/21/10024:005, BMF-Schreiben zur steuerlichen Behandlung des Arbeitslohns nach den Doppelbesteuerungsabkommen*.

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