Canadian Tax Issues for Public Company Stock Options

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Outline

- Tax implications for Canadian pubco employers
- Tax consequences for Canadian resident employees
- Cash-outs
- Independent consultant
- Non-resident employee
- Examples

Employers - (Pubco resident in Canada)

- Stock option expense for accounting purposes are generally not deductible for calculating taxable income

- When Canadian employees exercise options, income tax and CPP must be withheld at source

- When Canadian employees exercise options, tax reporting slips (T4) must be issued before the end of February of the following year

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Employees (resident in Canada)

- Employees include officers or directors of the company
- Stock option benefit =
  FMV of shares on exercise – exercise price of the shares
- The stock option benefit is included in taxable income in the year exercised; taxed as employment income (CPP and taxes withheld)
- The tax cost of the shares acquired on exercise =
  Amount paid for the shares + stock option benefit before deduction (if any)

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Employees (resident in Canada)

- 50% deduction on stock option benefit for publicly traded company shares if:
  - Employee is at arm's length with the corporation;
  - The value of the shares when the option agreement is entered into did not exceed the exercise price of the option; **and**
  - Common shares are received on exercise of option.

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Employees (resident in Canada)

- If the common shares are held as capital property when the shares are sold and…
  - A lift in value of the shares since exercise → results in a capital gain → 50% is included as a taxable capital gain
  - Value of the shares decreased since exercise → results in a capital loss → 50% of capital loss is deductible against taxable capital gains in the year of realization (any excess may be carried back 3 years and forward indefinitely)
- If the shares are immediately sold after exercising the stock option, there should be no capital gain / loss

Timelines / taxable events

Grant date

Options exercised

Sale of shares

Employee holds options

Employee holds shares

No tax consequence on grant date

Stock option benefit is recognized in the year which the shares are **acquired**

50% deduction against the taxable benefit if conditions are met

Taxable capital gain or loss, depending on the value of shares at the time of sale

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Cash Outs

- Disposal of stock option rights for cash (or equivalent) rather than for stock would be treated as ordinary remuneration
  - The cash payment is deductible from taxable income for the corporation
  - The cash payment is fully taxable in the employees' hands

- Exception, if the corporation elects not to take the deduction and provides a copy of the election to the employee, then a cash out plan can be treated as an equivalent to a stock option plan, and the employee may be eligible for a 50% deduction

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Independent Consultant

- An independent consultant that is not an employee should report the **value** of the stock **option** as business income
- No tax implications upon exercising the stock option
- The cost of the shares acquired = exercise price + value of the stock option previously included as business income
- Upon disposition of the shares, a taxable capital gain or loss may occur

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Non-Resident Employee

- Non-resident employee granted and exercising stock options who provides **no services in Canada** is not subject to Canadian tax on stock option benefits
- Generally, if the non-resident employee is physically present in Canada, then there may be Canadian tax implications

Example 1 – Capital Gain (Employee)

Grant date

Options exercised

Sale of shares

Employee holds options

Employee holds shares

100,000 stock options issued
Exercise price = $0.50

No tax consequence

Trading at $0.60 on exercise

Taxable benefit of $10,000
($0.60 – $0.50) x 100,000 shares

Deduction of $5,000 (as a qualifying option)

Sold shares at $0.75

Taxable capital gain of $7,500
($0.75-$0.60) x 100,000 x 50%

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Example 1 – Capital Gain (Employee)

- Taxable income:

Taxable benefit	$	10,000
Less: deduction		(5,000)
Taxable capital gain		7,500
Taxable income	$	12,500

- Assuming 50% marginal tax rate, results in tax of $6,250

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Example 1 – Capital Gain (Employee)

- End result (cash flow):

Sale of share proceeds	$	75,000
Purchase of share		(50,000)
Tax		(6,250)
Net cash in pocket	$	18,750

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Example 2 – Capital Loss (Employee)

Grant date	Options exercised	Sale of shares
Employee holds options	**Employee holds shares**	
100,000 stock options issued Exercise price = $0.50	Trading at $0.60 on exercise	Sold shares at $0.51
No tax consequence on grant date	**Taxable benefit of $10,000** ($0.60 – $0.50) x 100,000 shares **Deduction of $5,000** (as a qualifying option)	**Allowable capital loss of $4,500** ($0.51-$0.60) x 100,000 x 50%

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Example 2 – Capital Loss (Employee)

- Taxable income:

Stock option benefit	$	10,000
Less: deduction		(5,000)
Taxable income	$	5,000

- Assuming 50% marginal tax rate, results in tax of $2,500
- Allowable capital loss of $4,500 is applied first against current year capital gains and then may be carried back 3 years or forward indefinitely

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Example 2 – Capital Loss (Employee)

- End result (cash flow):

Sale of share proceeds	$	51,000
Purchase of share		(50,000)
Tax on stock option benefit		(2,500)
Net cash in pocket	$	(1,500)

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Recap / Wrap-up

- Stock option benefit =
  Value of shares at the time of exercise – exercise price
- Stock option benefit → taxed as income (like remunerations paid) and is subject to CPP and income taxes withheld at source
- 50% deduction available if criteria are met
- Possibly a capital gain or loss on sale of shares, if shares were held as capital property
- Capital loss must first be applied against current year's capital gain, otherwise carried back 3 years or forward indefinitely, but <u>cannot</u> be applied against stock option benefit

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