Canadian Tax Issues for Company Stock Options

Jamie Nguyen, CPA, CA
Partner – Taxation Services

&Davidson Company

Outline

- Tax implications for Canadian employers
- Tax implications for Canadian employees
- Cash-out rights
- Independent consultant
- Non-resident employee
- Proposed changes

Employers

- When Canadian employees exercise options, stock option benefit must be computed by the employer.
- Income tax and CPP must be withheld at source and remitted to the CRA. T4 reporting required.
- S.153(1.31) – even if no cash is being paid on a stock option benefit, the employer must withhold (e.g. deduction from regular salary may be necessary). No withholding required for arm's length employee exercising CCPC shares.
- Employers generally not entitled to deduct stock compensation expense for tax purposes.

Employees

- S.248(1) – "employee" definition includes officers or directors of the company (often overlooked)

- Stock option benefit = FMV of shares on exercise – exercise price

- The stock option benefit is taxable in the year of exercise
  - *Exception:* for CCPC employers dealing at arm's length = benefit is only recognized when shares are disposed

- Tax cost of the shares acquired on exercise
  = Exercise price + stock option benefit + cost to acquire option (if any)
  (generally, tax cost will be the FMV of shares on exercise)

- Loans provided to acquire shares may result in taxable benefit or income inclusion for the loan itself.

50% Deduction

- S.110(1)(d) or (d.1) deduction effectively gives a capital gain treatment to the stock option exercise by allowing a 50% deduction on the stock option benefit. This deduction is only permitted to employees, and not contractors.

- The deduction is available if the employee meets any of these scenarios:

- **Scenario 1 – S.110(1)(d):**
  - Share is a prescribed share – e.g. common shares;
  - The value of the shares when the option agreement is entered into did not exceed the exercise price of the option; and
  - Employer and employee were dealing at arm's length at that time.

OR

- **Scenario 2 – S.110(1)(d.1):**
  - Employer is a CCPC dealing at arm's length with employee; and
  - Employee holds the shares for at least two years

Gains/Losses on Shares

- If the common shares are held as capital property when the shares are sold and…
  - Increase in value of the shares since exercise
    → results in a capital gain
  - Decrease in value of the shares since exercise
    → results in a capital loss
    - capital loss is deductible against capital gains in the year of realization (any excess may be carried back 3 years and forward indefinitely)
    - Capital loss cannot offset the S.7 benefit - punitive
- If the shares are immediately sold after exercising the stock option, there should be no gain/loss; only the S.7 benefit applies

Timing / Valuation Issues

- Generally, taxation and reporting of option exercise occurs when the employee acquires ownership of publicly traded company shares.

- *Van De Velde 2007 TCC* – CRA argued that restricted stock units (RSUs) should be valued on *grant date*. However, court concluded that the benefit received by the taxpayer should be valued when the RSUs *vested* as this was when legal ownership was acquired.

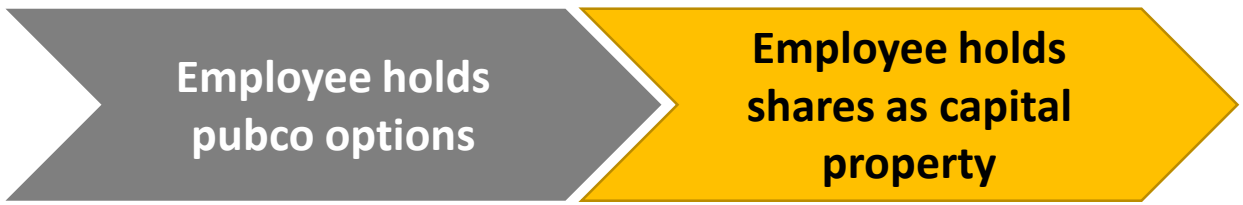
- CRA has stated that the share's value for the stock option benefit can be discounted to reflect selling restrictions. However, the CRA has also stated that the valuation may be impacted by potential earnout clauses.

Timeline - Taxable events

i) Grant date

ii) Options exercised

iii) Sale of shares



No tax consequence on grant date for pubco employee

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

50% deduction against the taxable benefit if conditions are met

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

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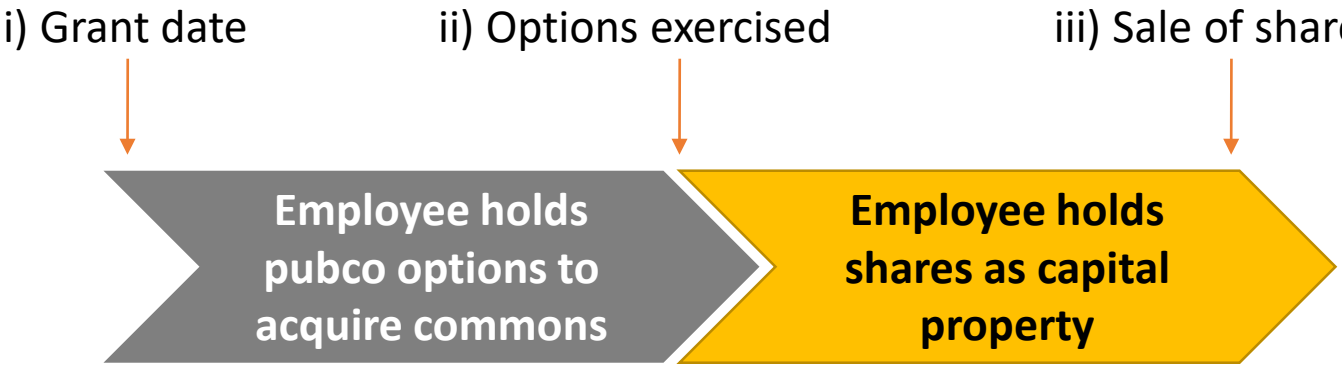
Timeline - Example



- Exercise price = $1
- FMV of share on grant date = $1
- Did not pay to acquire the option
- Dealing at arm's length

- FMV of share on exercise date = $3
- Stock option benefit = $3 - $1 = $2
- 50% deduction = $2 x 50% = $1
- Taxable income = $2 - $1 = $1

- FMV of share on eventual sale date = $8
- Capital gain on sale = $8 - $3 = $5
- Taxable capital gain = $5 x 50% = $2.50

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Cash-Out Rights

- Disposal of stock option rights to the employer for cash or in-kind benefit is considered a cash-out payment.

- Generally, employee is not entitled to claim 50% deduction in this case, resulting in a full income inclusion of the stock option benefit.

- *Exception*: if the corporation *elects* not to take the cash-out as a corporate expense *and* makes an election to do so under S.110(1.1), the employee will be eligible for the 50% deduction

Independent Consultant

- An independent consultant (i.e. not an employee) that is granted stock options does *not* fall under the S.7 stock option benefit rules. CRA's position on the taxation of the stock options for contractors is as follows:

- ***Taxation on Grant date*:**
  - Where an option is *granted* to the consultant as payment for consulting services, the fair market value of the option on the grant date less any amount paid for the option will generally be included in the consultant's *business income* (S. 9(1)). The determination of the FMV of the option on grant date is a question of fact.

Independent Consultant

- ***Taxation on Exercise Date*:**
  - When the option is *exercised*, the incremental value realized on the acquisition of the shares through the exercise of the stock option (generally FMV of share on exercise date - (exercise price + value included in the income at the grant date)) will have to be included in the consultant's income.

  - CRA's has stated that this incremental value realized on the exercise may be business income (100%) or capital gain (50%), depending on facts and circumstances.

  - This CRA position may be based on the consultant providing *future services* with respect to the options initially received.

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Independent Consultant

- Other tax considerations for independent consultants include:
  - *GST* – this will still apply to the consulting services, even if payment is in the form of options instead of cash. Often missed due to non-cash nature of options.
  - *Non-residency matters* – Reg.105 requires 15% withholding tax for payment of fees for services rendered in Canada by non-resident.
  - *Valuation* - CRA has stated the FMV of an option is the greater of:
    - the trading value of the rights received; and
    - the amount by which the FMV of the shares subject to the option at the grant date exceeds the exercise price provided in the option.

Non-Resident Employee

- Non-resident employee granted and exercising stock options is only subject to Canadian taxation where services are provided in Canada.

- Where employment duties are performed *both* in Canada and another country, CRA sources the benefits based on days of employment during the period between the option grant and its vesting date.

- Generally, if the non-resident employee is physically present in Canada, the same tax implications will apply as Canadian resident employees (e.g. withholdings, T4, T1 filing).

Overview of Proposed Changes

- Finance believes that the 50% stock option deduction disproportionately accrues to a small number of high-income individuals, “resulting in an unfair tax treatment that benefits the wealthiest Canadians”.

- Finance announced *proposed* changes to limit access to the 50% deduction on stock option exercises. Focus of rule changes is on non-CCPCs (e.g. public companies).

- If enacted, employee stock options granted on or after January 1, 2020 would be subject to these new rules. Existing options would not be affected.

Details of Proposed Changes

- There will be a $200,000 limit on the amount of employee stock options that may vest in an employee in a year and continue to qualify for the 50% stock option deduction.

- Any options exercised that exceed the limit will be subject to the full employment taxable benefit for the employee. However, the employer will now be entitled to a deduction for the portion that exceeds the limit.

Details of Proposed Changes (cont'd)

- If the amount of stock options that may vest in a year exceeds $200k those employee stock options granted first will be the first to qualify for the stock option deduction.

- Employers that are CCPCs will not be subject to the new rules. Certain types of non-CCPC start-up entities may also be exempt from the new rules.

Example of Proposed Changes

- Henry is an executive of a corporation that is subject to the new employee stock option tax rules.
- In 2020, Henry's employer grants him stock options to acquire 50,000 shares at a price of $50 per share (the fair market value of a share on the date the options are granted), with the options vesting in 2021.
- Since the fair market value of the underlying shares at the time of grant in the vesting year ($50 × 50,000 = $2.5 million) exceeds the $200,000 annual limit, the amount of stock options that can receive the preferential 50% deduction will be capped.

Example of Proposed Changes (cont'd)

- **Result**: Only the stock option benefits associated with 4,000 ($200,000 ÷ $50/share) of the options in the vesting year can continue to receive the preferential 50% deduction. The stock option benefits associated with the remaining 46,000 options in the vesting year will be included in Henry's income and *fully taxed* at ordinary rates without the 50% deduction.

- Henry's employer will be entitled to a full deduction for corporate income tax purposes with respect to the 46,000 options.

Comments on Proposed Changes

- Will new government enact these rule changes?

- Given that the new rules apply to options granted on or after January 1, 2020, employers may wish to consider granting options in 2019 year in order to fall under the old rules.

- Supporting documentation for the fair market value of the share at the grant date will likely become more critical.

Recap

- Stock option benefit is taxed as income (like remunerations paid) and is subject to CPP and income taxes withholdings at source. T4 reporting required.
- 50% deduction available if criteria are met
- Possibly a capital gain or loss on later sale of shares if shares were held as capital property
- Independent consultants have very different tax treatment from employees – do not assume the same.
- Possible new changes to limit access to 50% deduction for employees.

Questions?