

Taxation of Employee Stock Options

A common incentive program provided by Canadian employers is a stock option plan. These programs grant employees (including directors) the right to acquire a set number of shares of the employer (or parent) company at a fixed price (“exercise price”) within a set timeframe. The intention of these programs is to align employee/ employer interests by providing a long-term incentive in which employees benefit from the success of their employer, and likewise, employers benefit from long-term, loyal employees. This publication provides an overview of the Canadian tax implications of stock options issued to employees who are resident in Canada for tax purposes.¹

Taxation of employee stock options

In general, where stock options are granted by a Canadian public corporation there are no immediate tax implications; instead the employee will include in his/her income, a stock option benefit (as employment income) in the taxation year in which the options are exercised.² This stock option benefit is equal to the difference between the fair market value (“FMV”) of the shares at the time of exercise and the exercise price (i.e., the price paid by the employee pursuant to the option agreement to purchase the underlying stock). This is illustrated as follows:

Stock Option Benefit Calculation	
Stock options granted	1,000
Stock option grant price	\$2/share
FMV on exercise date	\$10/share
Stock Option Benefit	
1,000 shares x (\$10 - \$2)	\$8,000

Once the employee has acquired the shares pursuant to the option agreement, the employee’s adjusted cost base (“ACB”) of the shares for tax purposes will include the exercise cost and the stock option benefit, such that their ACB will generally become the FMV of the shares at the date of exercise. This is due to the fact that tax has been paid on the

stock option benefit and applies regardless of whether or not the potential 50% offsetting deduction applies, as discussed in the next section.

ACB Calculation

Exercise cost: 1,000 shares x \$2	\$2,000
Add: Stock option benefit	<u>\$8,000</u>
ACB	\$10,000

Potential 50% deduction

As previously described, the exercise of employee stock options creates a stock option benefit that will be taxed as employment income. However, in determining the tax implications of acquiring shares pursuant to the exercise of a stock option, a deduction equal to one-half (i.e., 50%) of the taxable benefit is potentially available, where the following conditions are met:

- The employee deals at arm’s length with the issuer/ employer corporation;
- The exercise price is not less than the FMV of the shares at the time the stock options were granted; and
- The shares acquired are considered “prescribed shares” (generally these represent “plain vanilla” common shares).

The net taxable amount after applying the 50% offsetting deduction (illustrated below), if applicable, is subject to taxation at the employee's marginal tax rate.

Stock Option Deduction	
Stock option benefit (as previously calculated)	\$8,000
Less: Stock option deduction (i.e., 50%)	<u>\$4,000</u>
Net Taxable (Employment) Income	\$4,000

Where an employee's stock options qualify for the 50% deduction, the stock option benefit is effectively taxed as a capital gain, though it still represents employment income for tax purposes. Accordingly, this income cannot be offset by a capital loss (including any capital loss realized on the subsequent sale of any optioned shares at a trading value that has declined following the exercise of the options).

It is important to note that under Quebec tax legislation, generally, employees are only entitled to a 25% deduction of the stock option benefit; leaving 75% (versus 50%) of the benefit taxable for Quebec provincial tax purposes.³

Source withholdings

As previously noted, since a stock option benefit is received as part of an employee's remuneration, this benefit is considered employment income. Therefore, the employer is required to withhold and remit appropriate source deductions to the Canada Revenue Agency (the "CRA").

In determining the appropriate source deductions for the employment benefit upon exercise, the offsetting 50% deduction can be taken into account, where applicable. However, typically the employer will look to the employee exercising the options to fund the required withholding. Consequently, it may be necessary for the employee to immediately sell some shares acquired to satisfy the tax remittance (in addition to the acquisition costs to exercise the stock options).

Stock option "cash-outs"

The issuance of shares upon the option exercise does not provide a tax deduction to the employer. However, in certain situations where the employee receives a cash payment for disposing the rights under their option agreement, the cash

payment may be deductible to the employer. Prior to the 2010 federal budget, it was also possible for the employee to receive the 50% offsetting deduction from their income in these scenarios.

However, the 2010 federal budget eliminated this asymmetry on stock option 'cash-outs' by restricting the employee's ability to claim the 50% deduction where the employer also claims a tax deduction for the cash payment (where shares are not issued). As such, unless the employer elects otherwise, an employee can claim the 50% deduction only if he/she actually acquires the shares pursuant to the stock option agreement which may not occur, for example, where an employee's rights under the stock option agreement are bought out in a corporate take-over scenario. On the other hand, these scenarios should be distinguished from a 'cashless' exercise, where the employee actually acquires the option shares but then sells them immediately; which can still qualify for the aforementioned 50% deduction despite these amendments.

Stock options of Canadian Controlled Private Corporations

In contrast to the taxation upon exercise for public company stock options, where stock options are issued by a Canadian Controlled Private Corporation (CCPC), the taxation of the employment benefit is deferred until the employee disposes of the shares. This deferral recognizes the reduced liquidity for CCPC shares versus public company shares. In this determination, it is important to note that the tax rules only require that the issuer corporation be a CCPC at the time of granting (provided that the employee dealt at arm's length with the CCPC/issuer), such that the beneficial CCPC rules governing employee stock options could still apply even if the company subsequently ceases to be a CCPC.

Where an employee exercises CCPC stock options, the taxable benefit is calculated in the same manner as a public corporation and the offsetting 50% deduction is available based on the criteria previously outlined. However, the 50% deduction is also available under an alternative provision if the employee held the (optioned) CCPC shares for at least two years after acquisition, before disposing of the shares. As such, a CCPC stock option benefit may still qualify for the

50% deduction even if the option was issued with an exercise price below the FMV of the shares at grant date, provided this holding period test is met.

In addition, the aforementioned requirements to withhold and remit source deductions for the taxable stock option (employment) benefit do not apply where the taxation of the benefit is deferred under the above rules applicable to CCPCs.

Finally, it is also worth noting that certain CCPC shares may qualify for the enhanced lifetime Capital Gains Deduction (of up to \$824,176 for 2016) on capital gains realized on a future sale, if the shares meet the Qualifying Small Business Corporation (QSBC) criteria. For more information, please ask your BMO financial professional for a copy of our BMO Wealth Management publication entitled "Tax Planning for Small Business Owners – The Capital Gains Deduction."

Subsequent disposition of shares – Capital gain/loss calculations

Once an employee has exercised their stock options and acquired shares, a capital gain/loss will apply on a subsequent sale or disposition, based on the proceeds received less the ACB of the shares, as illustrated below. As previously outlined, the acquisition costs to exercise the options and the stock option benefit (i.e., the difference between the exercise price and FMV) are included in the ACB calculation, such that the ACB of the shares is generally equal to the FMV of the shares on the exercise date.

Subsequent Share Sale – Immediate Sale (e.g. "cashless exercise")

Proceeds of disposition	
1,000 shares x \$10	\$10,000
ACB (as previously calculated)	<u>\$10,000</u>
Capital Gain (Loss)	\$0

Subsequent Share Sale – In an Appreciating Market

Proceeds of disposition	
1,000 shares x \$12	\$12,000
ACB (as previously calculated)	<u>\$10,000</u>
Capital Gain (Loss)	\$2,000
Taxable Capital Gain (50%)	\$1,000

Subsequent Share Sale – In a Depreciating Market

Proceeds of disposition	
1,000 shares x \$9	\$9,000
ACB (as previously calculated)	<u>\$10,000</u>
Capital Gain (Loss)	(\$1,000)
Allowable Capital Loss (50%)	(\$500)

NOTE: This capital loss cannot offset the stock option benefit on exercise, since the benefit represents employment income for tax purposes.

However, where an employee already owns other shares of the (employer) company, the ACB of all (identical) shares will be averaged amongst the total shares held. Alternatively, where stock options are exercised and the optioned shares are sold immediately, or within 30 days of exercise (and no other identical shares are acquired or disposed during this period), the ACB of the optioned shares sold will not be averaged and can be isolated to that specific sale (of the newly-optioned shares) to prevent the recognition of any accrued gain or loss on the existing shares held. A similar rule will apply to isolate the employee's tax cost base of CCPC shares acquired pursuant to a stock option exercise, even when the shares are not disposed of within 30 days of acquisition.

Stock options with foreign employers

Often, a Canadian resident is employed by a Canadian subsidiary of a U.S. or other foreign company, which provides a stock option plan to acquire shares of the (public) foreign parent company. Because most employers have one plan for all employees over multiple jurisdictions, the stock option plan may not meet the Canadian tax requirements for the 50% stock option deduction. In addition, if the employee provided employment services outside of Canada, the employee may be subject to taxation in that foreign jurisdiction on the stock option benefit which entails additional tax implications. Further, there may be filing/reporting requirements in the foreign jurisdiction or other tax implications (e.g., U.S. estate tax, non-resident withholding tax) associated with owning options/shares of foreign corporations that will need to be considered, in addition to any Canadian tax implications and reporting obligations (e.g., the CRA's foreign reporting Form T1135).

Stock option taxation at death

When an individual dies holding unexercised stock options, the individual may have a deemed employment benefit arise at death. The deemed income inclusion for the deceased employee will be the difference between the FMV of the option rights immediately after death and the amount paid (if any) to acquire the stock options. Although the shares are not actually acquired by the deceased, draft legislation released recently provides potential access to the 50% deduction from this employment income inclusion, in certain circumstances where the shares are subsequently acquired and the required election is filed, within specific timeframes following death.

In cases where an employee stock option plan provides that the options are automatically canceled upon the death of an employee, the value of the options immediately after death will be nil with the result that no amount will be included in the deceased's income. However, in many cases the terms of a stock option agreement may allow the deceased's estate to exercise the stock option for a limited period (such as one year) following the employee's death, which could result in an income inclusion in accordance with the tax treatment outlined above. In some situations, the options may decline in value after the taxpayer's death, such that the benefit actually realized by the taxpayer's estate when the options are exercised, or disposed of, is less than the benefit required to be reported by the deceased taxpayer. However, in these situations, the tax legislation provides for an election to be filed (within the first taxation year of the deceased taxpayer's "graduated rate" estate) by the legal representative to deem a loss from employment to be realized by the deceased taxpayer for the year of death in order to reduce the income inclusion originally reported.

Donation of stock option proceeds

As outlined in our BMO Financial Group publication "Donating Appreciated Securities," Canadian tax law allows for the full elimination of any capital gains tax on donations of publicly-traded securities to a registered charity, in addition to the tax savings resulting from the charitable tax credit based on the value of the securities donated. Although the benefit received on the exercise of employee stock options constitutes

employment income – and not a capital gain – similar tax legislation provides for the possible reduction or elimination of this employment income benefit by donating the shares or proceeds acquired through the exercise of employee stock options.

To be eligible for this incentive, the option shares must be publicly-traded securities and the shares (or proceeds acquired through exercising the options) must be donated to a qualifying charity. The stock option benefit must also be eligible for the 50% deduction described previously. Assuming these qualifications are met, the reduced income inclusion is available if the shares are donated in the year acquired and within 30 days after the option exercise. In addition, in the case of a "cashless exercise," the reduced income inclusion may also be available if the employee directs their financial professional to immediately dispose of the securities acquired from employee's stock options and deliver the proceeds to a qualifying charity. If the value of the shares decrease in the (maximum) 30-day period before making the donation, or if only some of the shares (or aggregate proceeds) received by exercising the options are donated, the tax deduction will be reduced proportionately.

Speak with a professional

Each employer's stock option agreement is unique and the tax rules governing employee stock options are complex. As such, you will need to consult with your tax advisor to determine the specific tax implications of your compensation plan and any planning required in your particular situation.



Your BMO financial professional can assist in determining the broader financial implications of your stock options and other remuneration plans to your overall wealth management strategy.

Footnotes:

¹The information herein is based on the current tax legislation (and any outstanding tax proposals) as of the time of writing (September 2016). Although the federal Liberal government undertook a review of stock option taxation prior to its first budget in March 2016, no changes to the existing tax legislation governing stock options (outlined herein) were ultimately proposed in the 2016 federal budget.

² Prior to May 4, 2010, the Canadian tax legislation provided for a possible deferral election to have the stock option benefit taxed at the time the shares of a public company are sold versus exercised. Individuals who previously elected this option are encouraged to discuss the tax implications of a possible sale of their “deferred” shares with their tax advisor.

³ For simplicity, the potential stock option deduction has been referred to as a 50% amount throughout this publication, although the deduction for Quebec provincial tax purposes is generally only 25% (except that the employment benefit from stock options issued after March 13, 2008 by certain Quebec small and medium enterprises (SME) corporations involved in innovative activities may qualify for a 50% deduction for Quebec provincial tax purposes).



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