LEGAL BUSINESS REPORT ALPERT LAW FIRM
THE TAX LAW PROFESSIONALS

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EMPLOYEE STOCK OPTIONS

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on the potential liability of a corporation's directors under the Income Tax Act (Canada) and other taxation statutes. Alpert Law Firm is experienced in providing legal services to its clients in tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions and estate administration.

A. TAXABLE EMPLOYMENT BENEFIT

Section 7 of the *Income Tax Act* (the "Act") governs the taxation of employee stock options. Section 7 applies to options granted to an employee to acquire securities of (i) an employer corporation, (ii) an employer mutual fund trust, or (iii) a corporation or mutual fund trust not dealing at arm's length with the employer. The Act refers to these entities as "qualifying persons", which is defined, in subsection 7(7) of the Act, to include a corporation or a mutual fund trust. "Security" is defined as a share of the capital stock of the corporation or unit of a mutual fund trust.

An employee of a publicly traded corporation who exercises their right to acquire securities of their employer pursuant to an employee stock option agreement is generally deemed to receive a taxable employment benefit. As well, the employee is generally required to include in income, as an employee benefit, an amount equal to the difference between the fair market value of the stock at the time the stock option was exercised and the amount paid by the employee to acquire the stock option.

Subparagraphs 7(1)(a) to (e) of the Act apply to the following circumstances in which an employee is deemed to have received a benefit by virtue of employment:

(i) Acquiring Securities Under an Agreement

If an employee acquires securities under an agreement, whereby the employer agrees to sell or issue securities of the employer, the employment benefit is deemed to have been received in the year in which the securities are acquired. However, if either subsection 7(1.1) or (8) of the Act applies, then the benefit is deemed to have been received in the year in which the employee disposes of the securities. Pursuant to subparagraph 53(1)(j) of the Act, the amount of the deferred benefit is added to the adjusted cost base of the securities at the time of acquisition.

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Under subsection 7(1.1) of the Act, a deferral is available for stock options granted by a Canadian Controlled Private Corporation ("CCPC"), on the condition that immediately after the option is granted, the employee deals at arm's length with the employer. The deferral still applies even if the employer, while having CCPC status at the time the option was granted, ceases to be a CCPC prior to the time the securities are issued under the agreement. Furthermore, pursuant to subsection 110(d.1), if the employee does not dispose of or exchange the securities within two years of acquiring them, then the employee is permitted to deduct one-half of the benefit from income.

Under subsection 7(8) of the Act a deferral of an employment benefit is available for options to acquire publicly-listed shares or units in mutual fund trusts. Such deferral applies to any "qualifying acquisition" of a security, a term which is defined in subsection 7(9) of the Act. This deferral is elective at the option of the employee, who must be a resident in Canada at the time of the acquisition of the security. However, it is important to note that the election must be made in respect of each security for which the deferral is sought. For options that vest or become exercisable in a particular year, subparagraph 7(10)(c) of the Act provides for an annual vesting limit, under which the election to defer the benefit resulting from the exercise of the option is limited to $100,000 worth of securities acquired under the options. The employee must file an election with the employer before January 16 of the year following the year in which the security is acquired. But such election can be revoked, if this is done by January 15 of the year following the year in which the security is acquired. An employee may want to revoke an election to apply the vesting limit to other securities acquired that may have a larger deferred benefit.

(ii) Transfer or Disposition of a Right to Acquire Securities to Arm's Length Party

Under subparagraph 7(1)(b) of the Act, if an employee transfers or disposes of a right to acquire securities to an arm's length person, then the employment benefit is deemed to be received in the taxation year in which the employee made the disposition. However, subparagraph 7(1)(e) of the Act provides that this rule does not apply where the disposition was a result of the employee's death. Instead, the benefit would be deemed to be received in the year of the employee's death, and is deemed to be the amount by which the value of the right immediately after the death exceeds the amount the employee paid to acquire the right.

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(iii) Transfers of a Right to Acquire Securities

Under subparagraph 7(1)(c) of the Act, if an employee's right to acquire securities is transferred by one or more transactions between non-arm's length persons and the transferee has acquired securities under the agreement, the employment benefit is deemed to be received by the employee in the taxation year in which the transferee of the right acquired the securities, regardless of the time of payment. However, if the employee is deceased at the time the transferee acquires the securities, then the benefit is deemed to have been received by the transferee in that year as employment income. Such income is deemed to be earned in the country where the employee who transferred the securities primarily performed the employment duties.

Pursuant to subparagraph 7(1)(d) of the Act, if an employee's right to acquire securities is transferred by one or more transactions between non-arm's length persons to a transferee, who then disposes of the right to a person with whom the transferee was dealing at arm's length, then the employment benefit will be deemed to be received by the employee in the tax year in which the arm's length disposition was made. If the employee is deceased at the time, the above-mentioned rule applies.

(iv) Corporate Reorganizations or Amalgamations

Where an employee disposes of an option to acquire securities in exchange for another option pursuant to a corporate reorganization or amalgamation, then the rollover provisions in subsection 7(1.4) of the Act may apply. Pursuant to the rollover provisions, the following rules apply: (i) no disposition is deemed to have occurred; (ii) the new option would be the same as the original option; (iii) a deemed taxable benefit will not arise; and (iv) the deduction under subparagraph 110(1)(d) of the Act still applies. In order for the rollover to apply, the following conditions must be met:

(i) The employee must receive no consideration for the old option other than the new option, and

(ii) The fair market value of the new securities immediately after the exchange in excess of the old exercise price must not exceed the fair market value of the old securities immediately before the exchange in excess of the new option exercise price.

B. RECENT AMENDMENTS

On December 15, 2010, certain employee stock option provisions were amended as described below.

(i) Stock Option Cash-Out Payments

Many employee stock option agreements provide cash-out rights, whereby the employee can elect to receive a cash payment (equal to the employee stock option benefit) instead of the shares at the time the option is exercised. Previously, the employee was eligible to receive the 50% reduction of the employee stock option benefit pursuant to subsection 110(1)(d) of the Act and the employer was entitled to claim a 100% corporate level deduction in respect of the cash payment pursuant to subsection 7(3)(b) of the Act.

An employee is only eligible to receive the 50% reduction of the employee stock option benefit after 4:00 p.m. EST on March 4, 2010 if the employer files a prescribed election agreeing to forgo claiming a corporate level deduction for the cash-out payment. This change presents immediate concerns for employees and employers equally. For employees, they must be cognizant of the fact that if they elect to exercise a cash-out right, they are not eligible to claim the 50% deduction unless the employer elects to forgo its deduction for the cash-out payment. Employers who provide cash-out rights will need to reassess whether they are prepared to forgo the cash-out payment deduction or whether they will eliminate outstanding cash-out rights and not provide new options with such rights.

(ii) Elimination of Tax Deferral Election

Previously, an employee of a publicly-traded corporation was able to elect to defer the taxation of his employee stock option benefit until the disposition of the optioned securities (or was deemed to have disposed of the shares on death, or on becoming a non-resident of Canada). This tax deferral election was repealed for employee stock options exercised after 4:00 p.m. EST on March 4, 2010.

There is also special relief for those individuals who elected to defer taxation of their employee stock option benefits until the disposition of the optioned securities and found themselves in the situation where the value of the optioned securities was less than the deferred tax liability resulting from the exercise of the options. Where an employee is required to include in income a qualifying deferred stock option benefit, the employee can elect to pay a special tax equal to the full proceeds of disposition of the

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optioned securities instead of the amount that would otherwise have been payable in connection with the exercise of the optioned securities. This special election is intended to apply to the disposition of optioned securities before 2015. However, an employee who disposed of optioned securities before 2010 was required to make the special election on or before the filing due date for the 2010 taxation year (typically, April 30, 2011).

(iii) Remittance Obligations

The provisions of subsection 7(1) of the Act are subject an employee stock option benefit to withholding tax requirements as if the benefit was a cash bonus payment. As a result, an amount in respect of tax on the employee stock option benefit is required to be remitted to the government of Canada by the employer. An employee is no longer able to claim “undue hardship” pursuant to the provisions section 153 of the Act as a result of the employee’s inability to meet the tax obligation associated with the employee stock option benefit due to a subsequent decrease in the value of the optioned securities. Consequently, the Minister no longer has the discretion to reduce the amount of withholding tax on the basis of claim made by an employee for “undue hardship” pursuant to the provisions of section 153 of the Act.

This measure does not apply to employee stock options granted before 2011 pursuant to a written agreement entered into before 4:00 p.m. EST on March 4, 2010 where the written agreement includes a condition restricting the employee from disposing of the shares for a period of time after exercise.

(iv) $200,000 Deduction Limit Proposed in 2019 Federal Budget

The 2019 Federal Budget proposed to limit availability of the employee stock option deduction by applying a $200,000 annual cap on employee stock option grants (based on the fair market value of the underlying shares at the time of grant) that may benefit from the 50% deduction pursuant to subsection 110(d.1) of the Act. This measure will apply only for employees of “large, long-established, mature firms” and there will be no cap for employees of “start-ups and rapidly growing Canadian businesses”.

On December 19, 2019, the Department of Finance announced that the proposed changes to the employee stock options regime will not come into force on the previously proposed date of January 1, 2020, and that further details regarding the proposed changes will be announced in the 2020 Federal Budget.

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Please contact Howard Alpert directly at (416) 923-0809 if you require assistance with tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions or estate administration.

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