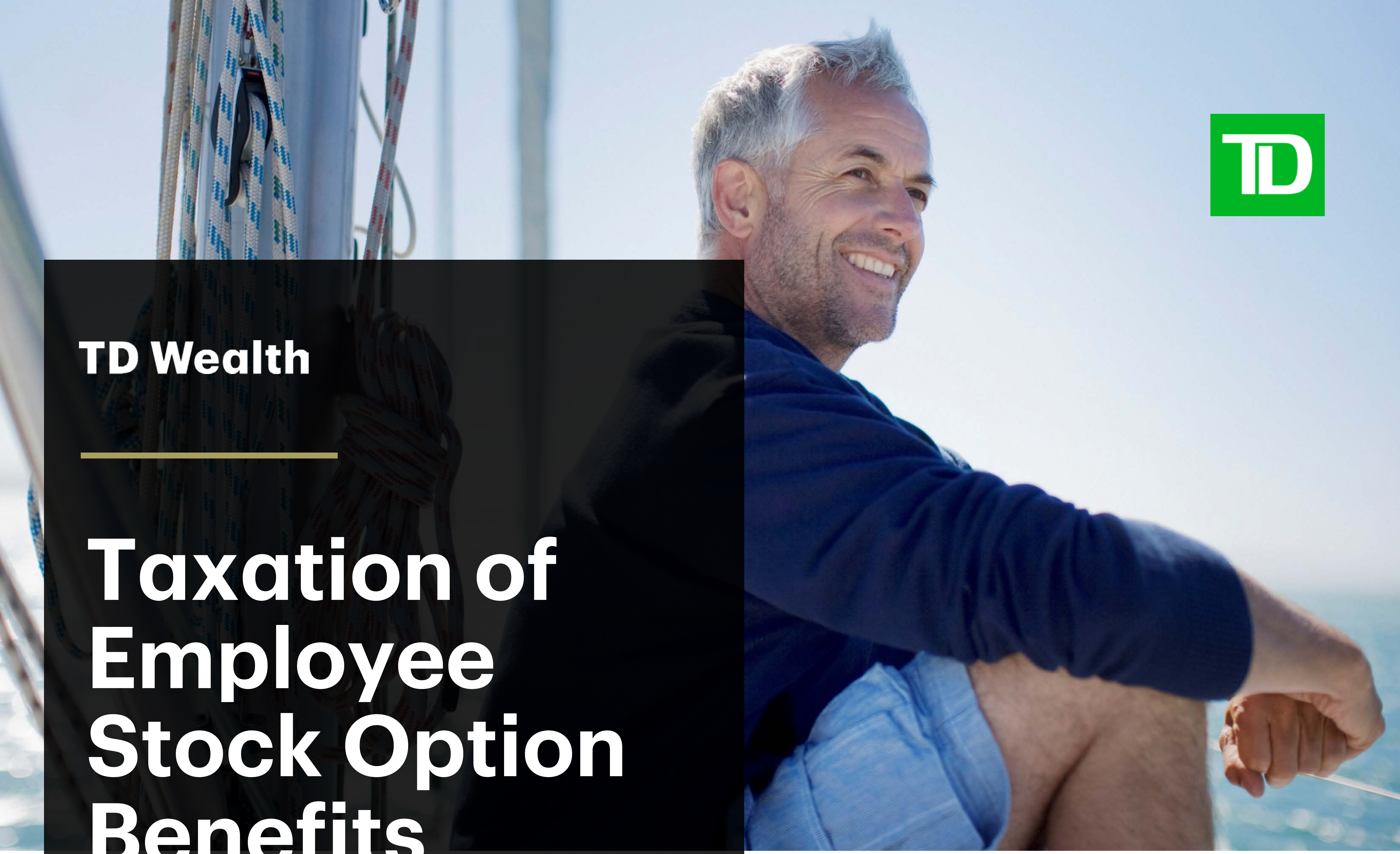


TD Wealth

Taxation of Employee Stock Option Benefits

A valuable incentive which a corporate employer can offer its employees is the right to acquire the employer's shares at a specified price. Many common employee compensation plans in Canada are equity-based. They are intended to give employees an interest in the performance of the corporation's stock. These plans may provide for the acquisition of actual shares through granting of shares or stock options. Employees who receive stock options are granted the right to purchase shares of the corporation at a fixed price on a future date (i.e., the exercise date). If the stock increases in value during the period from the date of grant to the exercise date, the employee receives an employment benefit upon exercising the option to acquire the shares.

General Rule

The general rule for stock option benefits is that an employment benefit is received when an employee exercises the option, not when the employee received the option. The employment benefit is generally the difference between the fair market value (FMV) of the shares at the time the option is exercised, and the actual cost to the employee of the shares (i.e., the exercise price and the price paid, if any, to acquire the option). Once the option is exercised, the employment benefit is added to the employee's purchase price of the shares such that the employee's adjusted cost base (ACB) for tax purposes would be equal to the FMV of the shares at the time of exercising the option (i.e., ACB = employment benefit + exercise price + price paid to acquire the option). On a subsequent disposition of the shares by the employee, any resulting gain or loss is calculated and taxed under the capital gain and loss rules. Thus, there should be little or no capital gain or loss if an employee exercises his or her options to acquire the shares and then immediately sells the shares.

Offsetting Deduction under the General Rule

An employee, who exercises options and acquires shares, is entitled to an offsetting deduction equal to 50% of the amount of the employment benefit if certain conditions are met. This means the employment benefit is effectively taxed as if it were a capital gain. It is important to note that claiming this deduction does not result in any reduction to the employee's ACB of the acquired shares.

In general, the following requirements must be met in order for the employee to be able to deduct 50% of the stock option employment benefit:

- the employer corporation (or a corporation not dealing at arm's length with the employer corporation) is the issuer of the shares;
- the shares are "prescribed shares" (which generally mean ordinary common shares and not preferred shares) at the time of their sale or issue;
- the option exercise price must generally be no less than the FMV of the shares at the time the option is granted; and
- at the time immediately after the stock option agreement was made, the employee deals at arm's length with the employer corporation and, where applicable, with the issuer corporation (who does not deal at arm's length with the employer corporation).

For Quebec provincial tax purposes, generally the employment benefit deduction is limited to 25% of the stock option employment benefit. The deduction is increased to 50% for employees exercising options granted after March 13, 2017 to acquire shares of a small or medium-sized business (SMB) that is engaged in "innovative activities" for the calendar year in which the stock options are granted, or options granted after February 21, 2017 to acquire shares of a listed corporation with a Quebec payroll of at least $10 million for the calendar year which includes the time the stock option agreement was made or the time the shares were acquired.

2019 Federal Budget Proposals (Budget 2019) to Limit Preferential Tax Treatment of Employee Stock Options

In Budget 2019, the federal government announced its intent to limit the use of the current employee stock option tax regime, while recognizing that stock options can help small growing companies, such as startups, to attract and retain talent. The government proposes to limit the employee stock option deduction for high-income individuals employed at "large, long-established, mature firms" (a term not defined in Budget 2019).

The aim of these changes is twofold:
- to better align the employee stock option tax regime with the tax treatment in the United States, and
- to ensure that start-ups and emerging Canadian businesses that are creating jobs continue to grow and expand.

Budget 2019 proposes to introduce a $200,000 annual cap on employee stock option grants (based on the FMV of the underlying shares at the time of the option grant) issued to employees by these "large, long-established, mature firms". It states that the vast majority of employees receiving employee stock option benefits will be unaffected.

For "start-ups and rapidly growing Canadian businesses" (another term not defined in the Budget), employee stock option benefits will remain uncapped. Any changes will apply on a go-forward basis only; employee stock options granted prior to the announcement of legislative proposals to implement the changes will not be impacted.

The proposed changes were supposed to come into effect on January 1, 2020, but their implementation has since been delayed. The government intends to release further details about the proposed tax changes at a later date.

Exception to the General Rule – Employee Stock Options of a Canadian-controlled Private Corporation (CCPC)

There is an important exception to the general rule that the employee is subject to tax in the year the stock option is exercised. In the case of options on shares of a CCPC, taxation of the employment benefit can be deferred until the shares are disposed of by the employee. The tax policy behind this exception recognizes the limited marketability of CCPC shares in many cases.

A CCPC is generally a Canadian corporation whose shares are not listed on a designated stock exchange, and which is not controlled, directly or indirectly, by one or more public corporations or non-resident persons.

Stock options issued by a CCPC receive more favorable tax treatment in that there is a deferral of the employment benefit if the employee deals at arm’s length with the CCPC at the time immediately after the stock option agreement was made. If this condition is met, the employment benefit is deferred until the employee sells or otherwise disposes of the shares.

Furthermore, employees with options of a CCPC may be entitled to the 50% deduction of the employment benefit even if the exercise price of the option exceeds FMV of the shares at the time of grant, provided that the employee has held the shares of the CCPC for at least two years before disposing of the shares. The two-year holding period is waived in the case of a deemed disposition as a consequence of death. Where the employee satisfies the conditions for the 50% deduction under both the general and CCPC rules, s/he can only claim the deduction once.
As noted below, the withholding requirements do not apply to stock options granted by a CCPC with which an employee deals at arm's

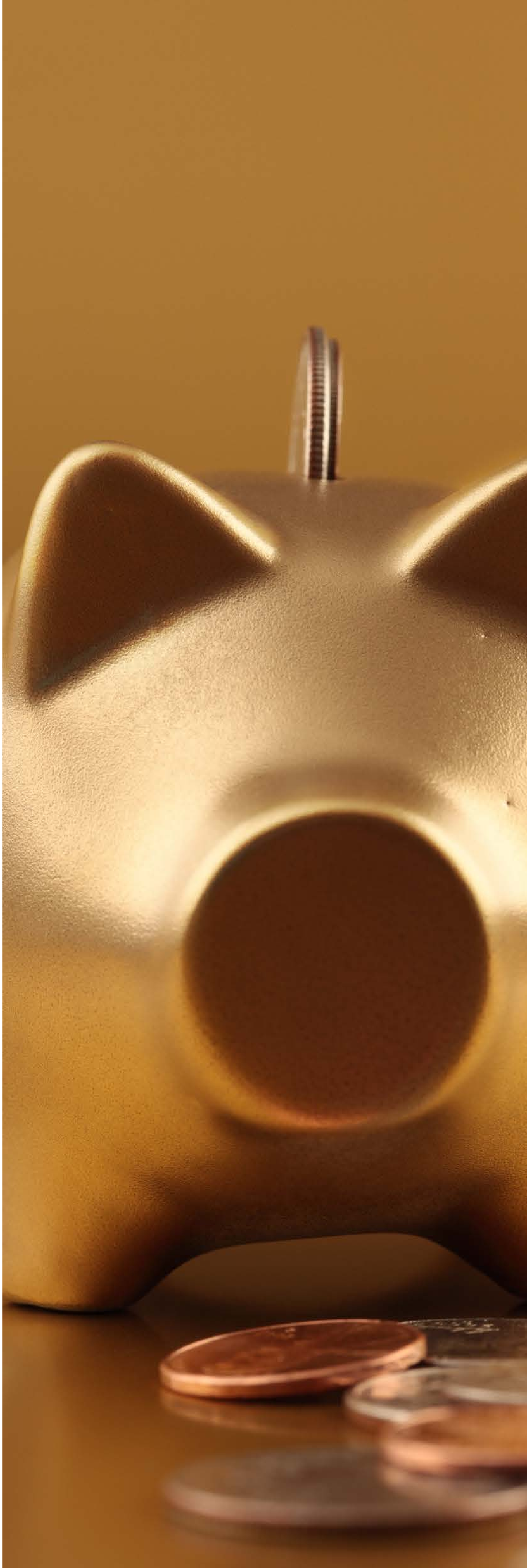
length. Thus, withholding is not required when the employee exercises options to acquire shares of a CCPC or when the employee disposes of such shares and realizes an employment benefit.

Source Withholding Requirements

An employer (or a person who does not deal at arm's length with the employer) who has granted stock options to an employee is required to deduct and withhold income tax on the employee's employment benefit which is considered as remuneration paid as a bonus. In granting stock options, employers may wish to consider how the withholding requirements may be administered and funded by employees.

No withholding tax is required in respect of:

- the portion of the taxable benefit eliminated by the 50% offsetting deduction under the general rule;
- the taxable benefit arising from the cashless exercise of stock options where all or a portion of the cash proceeds is donated to a registered charity under certain conditions; and
- the taxable benefit arising from the disposition of shares acquired as a result of exercising stock options granted by a CCPC.



Cost Averaging of Identical Shares

Under the general rule relating to identical properties, the ACB of a share is calculated as an average of all identical shares and determined by adding together their ACBs and dividing that number by the total number of shares.

In the case of shares acquired via stock option plans, a special rule applies: the employee has the option to designate such shares as the particular shares being sold so that the ACB averaging rule does not apply. This avoids the situation where ACB averaging may create a higher or lower capital gain due to a significant difference between the ACBs of two pools of shares.

To qualify for this special treatment, the shares acquired pursuant to the stock option plan must be disposed of within 30 days of the exercise of the option and the employee must not have acquired or disposed of any other identical shares from the exercise date to the date of sale.

Contribution to a Registered Retirement Savings Plan (RRSP)

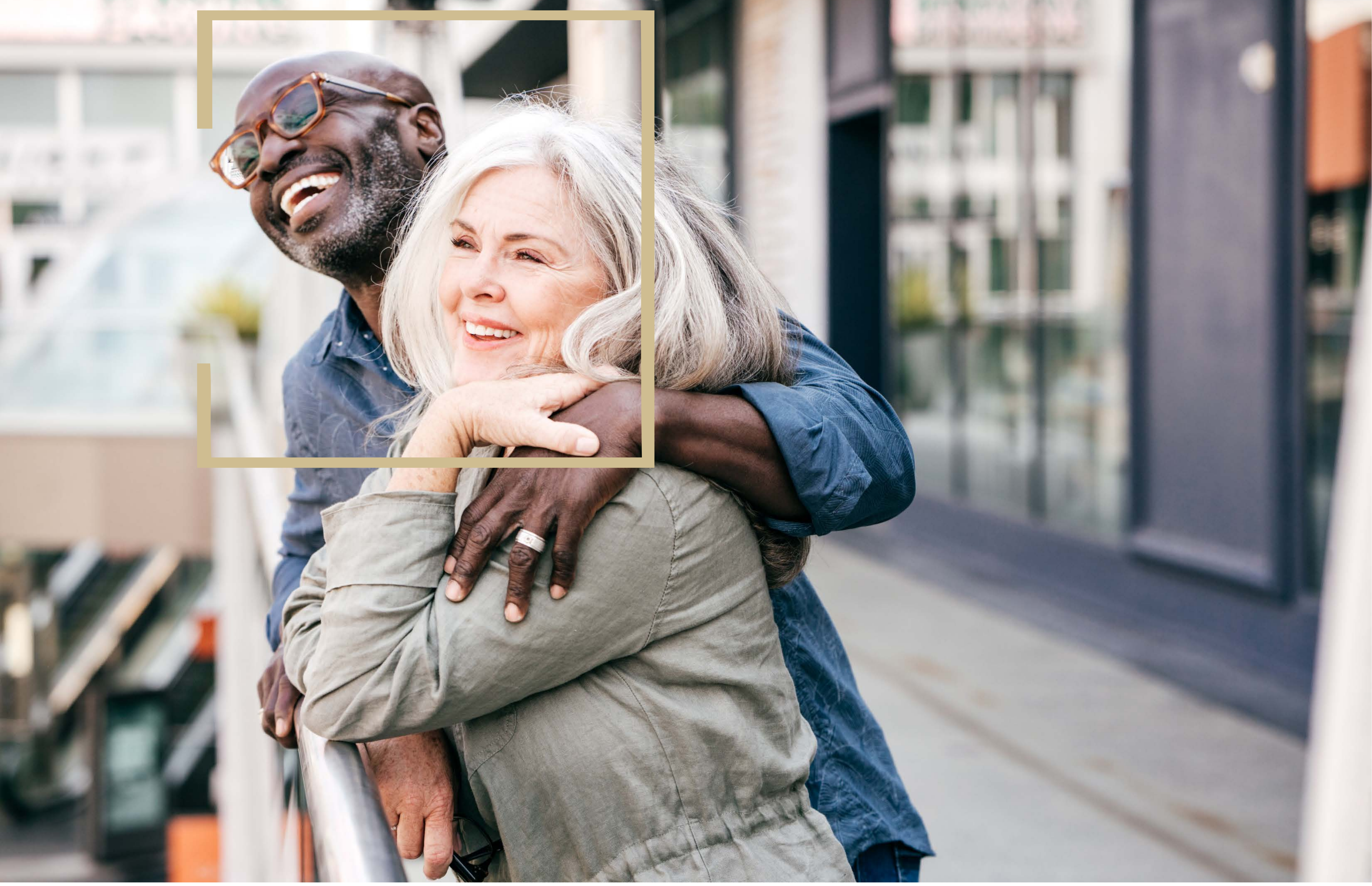
Stock options can be contributed in-kind to an RRSP so long as the underlying security is an eligible investment for RRSP purposes. The amount of the in-kind contribution is the difference between the FMV of the security at the time of contribution and the exercise price of the stock option.

An RRSP only shelters investment income and capital gains earned within the RRSP; it does not shelter employment income earned by the annuitant and stock option benefits (being taxable employment benefits) are taxable in the annuitant's hands. Therefore, the employee will have a taxable employment benefit when the options are exercised, unless the options relate to shares of a CCPC.

Charitable Donations

An individual who exercises employee stock options and donates the shares may be able to fully eliminate his/her employment benefit and capital gains arising from the option if the following conditions are met:

1. The stock option qualifies for the 50% deduction under the general rule,
2. The shares are listed on a designated stock exchange, and
3. The shares are donated to a registered charity within 30 days of the exercise date and within the same calendar year,



If there is a cashless exercise of stock options and a broker or dealer approved by your employer is directed to immediately sell the shares and donate all or a portion of the net proceeds to a registered charity, the individual will also be entitled to a deduction. In general, the deduction would be reduced proportionately based on the amount of proceeds donated relative to the value of the shares.

In both cases, the employment benefit from the option and the capital gain, if any, is eliminated and the individual is entitled to a donation tax credit equal to the FMV of the shares or proceeds donated.

On Death

A deceased employee is deemed to have received an employment benefit immediately prior to death; the benefit essentially being the difference between the value of the option immediately after death and the exercise price of the option. The employment benefit may be reduced by a 50% offsetting deduction.

If the value of the option decreases after death and the option is exercised by the estate, the employment benefit included in the terminal return of the deceased will have been overstated. The *Income Tax Act* (Canada) permits the deceased's legal representative to elect (within the first taxation year of the graduated rate estate) to treat the reduction in value of the stock as a loss from employment for the year in which the employee died. **The deceased's legal representatives must be aware of this one-year deadline.**

It is important that the employee stock option agreement be reviewed to determine whether the estate is permitted to exercise the stock option. The options may expire upon the employee's death, in which case the value of the options immediately after death may be nil.

Where a deceased employee has already exercised the stock option, but the taxable benefit has been deferred because the shares are shares of a CCPC, the tax implications on death are as follows:

- The deferred stock option benefit is included as income in the terminal return of the deceased. If the deceased employee qualifies for the offsetting deduction, the employment benefit is reduced by 50%.
- On the deemed disposition of the shares:
    - If the price of the shares has increased after the exercise date, the taxable portion of the capital gain generated due to the employee's death is included in the terminal return of the deceased.
    - If the price of the shares has decreased after the exercise date, a capital loss has occurred. This loss can be utilized to reduce capital gains realized in the year of death or within any of the three previous years. Any remaining capital loss that cannot be utilized can be used to offset any other type of income in the year of death.

Be Aware of Capital Losses if Shares Are Not Immediately Sold

When an employee acquires shares under a stock option plan but does not immediately sell them and the value of the shares declines after acquisition, he or she is still taxed on the employment benefit, even though he or she has not realized any monetary gain. The Canada Revenue Agency's position is that by keeping the shares rather than selling them immediately, the employee assumes an investment risk. Note that the option benefit is taxed as employment income; therefore any capital loss triggered on the sale cannot be used to offset the employment benefit included in income.

Considerations

Speak with your tax advisor to understand more about how the employee stock options rules may affect you and to review the income tax considerations particular to your situation.

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