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Stock Options: Topical Issues and Recent Developments

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Overview - Taxation of stock options

Introduction

- General rules on stock options
  - Stock options are not included in employment income at the time of grant or vesting (subsection 7(3))
  - Taxable benefit (FMV of shares – exercise price) realized when option exercised (subsection 7(1))
  - Inclusion of taxable benefit in income deferred until shares sold if options granted by CCPC (subsection 7(1.1))
- If the option is issued with a FMV strike price (and other conditions met), employee can deduct 50% of the benefit (para 110(1)(d)
  - Now subject to an annual cap of $200,000
- If the options is granted by CCPC, an arm's length employee can qualify for 50% deduction by holding shares for 2+ years (para 110(1)(d.1))

$200,000 Annual Cap on 110(1)(d) Deduction

"Non-Qualified Security" Rules under Subsections 110(1.3) to (1.44)

- Annual $200,000 cap enacted in 2021; applies to options granted on or after July 1, 2021
- Applicable to options issued by companies that:
  - Are not CCPCs; and
  - Annual gross revenues in excess of CAD$500M on a consolidated basis as reported on the annual financial statements
- Options in excess of the annual cap are not eligible for 110(1)(d) 50% deduction – "non-qualified security"
- Employer can designate options to be "non-qualified security" even if not in excess of the cap

Application of the $200K Annual Vesting Limit

- $200K cap applied based on:
  - the FMV of the securities on the option grant date; and
  - the number of options vesting in the particular year
- Cap applied on an individual basis and based on year of vesting
  - Option considered vested in the year it first becomes vested
  - Where vesting not clear (performance or event based vesting conditions), option considered to vest pro-rata over the term of the agreement (up to 60 months).
- $200K limit applies to all options granted to non-resident employees regardless of amount subject to Canadian tax

Numerical Example (Department of Finance)

- Henry is granted 200,000 stock options that vest evenly over 4 years (2022 – 2025)
- FMV of shares at time of grant = grant price = $50 per share
- Assume Henry exercises ¼ of his options and FMV is $70 per share on exercise

	A	**B**	**A x B**	**C**	**D**	**(D-B) x C = E**	**F = 50% of E**	**E-F =G**
	Number of stock options granted	FMV @ Grant Date per share	Total Value of Options	Number of Options exercised in 2022	FMV at exercise date per share	Benefit @ exercise date	Stock option ded'n	Net Income
Assumptions:	200K (4 years)	$50	$10M	50K (200K/4 years)	$70			
Within 200K limit		$50	$200K	4K ($200K/$50)	$70	$80K ($70-$50) x 4K	$40K	$40K
Not within 200K limit		$50		46K (50K-4K)	$70	$920K ($70-$50) x 46K	Nil	$920K
Total taxable Income								**$960K**

Employer Deduction for Non-Qualified Securities

- Employer can deduct taxable benefit realized on exercise of “non-qualified security” (paragraph 110(1)(e))
  - Option benefit must have otherwise been deductible under s. 110(1)(d) – i.e. meet all qualifying conditions
  - If employee is non-resident, employee must be subject to Canadian income tax on benefit
  - Satisfied notification requirements in s. 110(1.9)
  - Employer deduction also available where securities are designated as non-qualified even if below the $200K threshold

Considerations – Application of the Cap where para 110(1)(d) Deduction Not Available

- Some uncertainty re: impact of options (RSUs, in-the-money options) not eligible for s. 110(1)(d) deduction
- All s. 7 awards could count towards the $200,000 cap, even awards that are by their terms not eligible for s. 110(1)(d) deduction (for example share settled RSUs)
- CRA guidance: to avoid this concern, employers should designate securities that do not give rise to a paragraph 110(1)(d) deduction as non-qualified securities under subsection 110(1.4)
  - May 2022 IFA Roundtable.
  - Notification also required?

Considerations – Cash Out of Non-Qualified Stock Options

- Employer deduction under s.110(1)(e) applicable under s. 7(1)(b) cash out?
- Employer only entitled to a deduction under s.110(1)(e) if employee is otherwise eligible for deduction under s.110(1)(d)
- Employee only eligible for s.110(1)(d) deduction on a surrender if employer elects under s.110(1.1).
  - Needed to read out s.110(1)(d)(i) – but prohibited by s.110(1.4)(b)
  - In cash out scenario, a designation under subsection 110(1.4) by the qualifying person prohibits that person from filing an election under subsection 110(1.1) to shift the deduction back to the employee.
- Different considerations between non-qualified status due to exceeding $200K cap vs. designated status?

Considerations – Ordering Rules

- Where multiple agreements vest in the same year, cap applies to options in order of grant (oldest to newest) (s.110 (1.42))
- Where grant includes qualified and non-qualified securities, deemed to exercise qualified before non-qualified (s. 110(1.41))
  - Advantageous to separate grants?
- Does ordering rule in s.110(1.41) also apply to s.7(1)(b) cash out? Practical consequences?

Considerations - Exchanges and Amendments to Grandfathered Options

- Options awarded pre-July 1, 2021 and exchanged under s.7(1.4) are grandfathered and the "new / exchanged" options will not be subject to the $200K annual cap.
  - Grandfathering rule is not in the *Income Tax Act* (Canada) but is in the enacting legislation Bill C-30.
- Prudent to fit within s. 7(1.4) in all cases?
  - Amalgamation
  - Re-pricing
  - Other amendments to the options
- Exchange of post- June 2021 options under s.7(1.4)
  - Some ambiguity on whether s.110(1.31) applies based on FMV of shares at time of exchange

Employee Emigration – Sourcing Considerations

Common Scenario

- Employer grants stock options to a Canadian-resident employee
- Employee emigrates offshore
  - No deemed disposition – “excluded property”
- At the time of emigration, only some of the stock options are vested
  - The remaining stock options vest after emigration
- Employee subsequently exercises the stock options

Case Law

- Sourcing of the stock option benefit depends on whether the stock options were granted by virtue of the taxpayer's employment at the time of grant:
  - Generally, courts have held that if the stock options were granted by virtue of the taxpayer's employment at the time of grant, the stock option benefit recognized upon exercise is entirely sourced to Canada even if the taxpayer is no longer resident in Canada in the year of exercise (*Hurd v R,* [1981] C.T.C. 209; *Hale v R,* [1990] 2 CTC 247*; and Mullen v R,* 2012 TCC 139))
- Unclear if vesting affects sourcing
  - In the cases cited above, the decisions either state that the stock options vested prior to emigration or do not specify when the stock options vested
  - It is unclear if the courts' analyses would change if the taxpayers left Canada before vesting

Emigration to the US [CD]

Article XV(1) of the Canada-US Tax Treaty

- Employment income taxed by state of residence unless employment is exercised in the other Contracting State

Paragraph 6 of the Diplomatic Notes: Annex B to the Convention (September 21, 2007)

- Sets out principles applicable to income of an individual in connection with the exercise or disposal of an option to acquire shares or units of the individual's employer.
- Proportion attributable to each country is determined by the following ratio:

$$\frac{\textit{the number of days in the relevant period during which the Contracting State was the individual's principal place of employment}}{\textit{number of days in the relevant period}}$$

- "Relevant period" means the time period between date of grant and date of exercise (not vesting period)
- "Principal place of employment" means the country in which the employee was physically present while exercising employment on a particular day (CRA Interpretation 2008-0300631C6)
- The apportionment approach under the Canada-US Tax Treaty is unique (no similar guiding principles in other treaties such as the Canada-UK Tax Treaty)

Emigration to Country (Other than US)

Pre-2012 – CRA Administrative Position

- "Non-resident taxpayer who was granted stock options while he was resident in Canada or employed in Canada will be taxable in Canada on the benefit realized when the options are exercised."
- Appears consistent with case law *(Hurd v R, [1981] C.T.C. 209; Hale v R, [1990] 2 CTC 247; and Mullen v R, 2012 TCC 139))*

Post - 2012 – CRA Administrative Position

- Adopted principles set out in paragraphs 12 to 12.15 of the OECD Commentary on Article 15 (Income from Employment)
- Stock option benefit generally presumed to relate to period of employment that is required as a condition for the employee to acquire the right to exercise (i.e., vesting period)
- Stock option benefit is apportioned to each source country based on the following ratio:

$$\frac{\textit{the number of days of employment exercised in that country}}{\textit{total number of days in the period during which the employment services from which the stock option is derived are exercised (i.e., vesting period)}}$$

Considerations

- Is there a basis to deviate from the CRA's approach?
- What if facts do not fit within CRA's administrative position
  - E.g. Performance based vesting terms vs. time based vesting terms
- Accelerate vesting of stock options prior to emigration