Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Taxation of employee stock options

Many companies use stock options to attract or reward employees, as it gives the employees the opportunity to share in the future growth of a company. Stock options are an incentive that aligns the goals of the employees with the goals of the company, as both benefit from an appreciation in the stock price. Stock options are also a popular form of compensation because they do not generally affect the company's cash flow.

The taxation of employee stock options can be complex, as there are a number of factors that determine how and when an employee stock option will be taxed. This article outlines the rules around the taxation of employee stock options and presents several common examples to help illustrate the rules.

Background

As an employee, you may have been granted stock options by your employer. Stock options give you the right to acquire shares of your employer corporation at a fixed price (the exercise price or strike price) on a future date.

Employers typically set vesting periods for options, meaning you must work at the company for a specified period of time before you can exercise the options. For example, your employer may grant you 1,000 options in Year 1, stipulating that you can exercise only 250 options annually in each of Year 2, Year 3, Year 4 and Year 5. Vesting periods are intended to give you incentive to stay at the company while still allowing you to benefit from the increase in the share price.

A key consideration in the taxation of employee stock options is the type of corporation issuing the stock option. The taxation of options depends on whether the company issuing the shares is a Canadian controlled private corporation (CCPC) or not.

A CCPC is generally a Canadian corporation, where the shares are not listed on a designated stock exchange. A corporation will not qualify as a CCPC if it's controlled by a public corporation, a non-resident, or a combination of both. A non-CCPC generally includes a public

corporation or a private corporation that does not meet the definition of a CCPC.

Non-CCPCs

Security options benefit

Generally, there are no tax implications when stock options are first granted to you. However, when you decide to exercise the options, the difference between the fair market value (FMV) of the shares on the day you exercise the options and the amount you pay for the shares (the exercise price or strike price) is considered to be a security options benefit.

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The security options benefit is taxable to you as employment income in the year you exercise the options, and is reported to you on your T4 tax slip, along with your salary, bonus and other sources of employment income.

The security options benefit is normally added to the adjusted cost base (ACB) of your shares. This ensures that the security options benefit is not taxed again on a subsequent disposition. The ACB of your shares will therefore include the exercise price and the security options benefit, such that the ACB will generally be the FMV of the shares on the date you exercised the options.

Future appreciation or depreciation of the shares after the exercise date, if you hold the shares and do not sell them immediately after exercising the options, is taxed as a capital gain or loss.

Security options deduction

Current rules – options GRANTED before July 1, 2021

You may be eligible for an offsetting security options deduction equal to 50% of your security options benefit, if certain conditions are met. Generally speaking, the deduction is available if:

- The employee stock option is in respect of common shares;
- The exercise price was not less than the FMV of the shares at the time the options were granted; and
- You're dealing with your employer at arm's length immediately after the stock options were granted.

The security options deduction is reported on your T4 slip. The deduction results in the security options benefit being effectively taxed at capital gains tax rates, even though the benefit is considered employment income. Since the income inclusion is not truly a capital gain, you cannot offset the income inclusion with capital losses.

Proposed rules – options GRANTED after June 30, 2021

As part of the 2019 federal budget, the government announced its intention to introduce changes to the preferential taxation of employee stock options and limit the availability of the security options deduction for employees of large, long-established, mature corporations. Draft legislation was released in June 2019 for public consultation. The proposed changes were initially to take effect on January 1, 2020, and apply to employee stock options granted on or after that date; however, the implementation of these measures was later postponed to allow the government time to consider responses received as a result of the consultation process. On November 30, 2020, the government released its Fall Economic Statement, in which it confirmed its intention to move forward with these proposed measures to limit the availability of the security options deduction. The government also provided updated draft legislation.

Under the proposed measures, the government will apply a $200,000 limit on employee stock options that may vest in a calendar year and continue to qualify for the 50% securities option deduction. For the purpose of the $200,000 limit, the amount of employee stock options that may vest in a calendar year and benefit from the security options deduction will be determined based on the FMV of the underlying shares at the time the options are granted. For example, if the FMV of the underlying shares at the time of grant is $100 and you were granted 3,000 options that vest in a particular year, you will be able to claim the security options deduction on only 2,000 of the options ($200,000/$100 = 2,000), assuming all of the other qualifications are met. As mentioned previously, an option vests when it first becomes exercisable. The determination of when an option vests will be made at the time the option is granted. If the year in which an option vests is unclear, the new rules provide that the option would be considered to vest on a pro-rata basis over the term of the agreement, up to a five-year period.

The $200,000 limit on the amount of employee stock options that may vest in any calendar year and qualify for the security options deduction will generally apply to all stock option agreements between the employee and employer or any corporation that does not deal at arm's

length with the employer. If an employee has two or more employers that deal at arm's length with each other, the employee will have a separate $200,000 limit for each of those employers.

If the amount of stock options that vest in a year exceeds $200,000, those employee stock options that were granted first would be the first to qualify for the security options deduction. If an employee has a number of identical stock options and some qualify for the tax treatment under the current rules while others are subject to the new tax treatment, the employee will first be considered to have exercised the stock options qualifying for the existing tax treatment. Therefore, it's possible that you may exercise options in a particular year where the current rules apply to some options exercised and where the new rules apply to other options exercised in the same year.

Where an employee exercises employee stock options granted after June 2021 that are in excess of the $200,000 limit, the employee will not be entitled to the security options deduction on the exercise of these options.

The proposed measures will apply to employee stock options that are granted by corporations or mutual fund trusts on or after July 1, 2021. The existing rules will continue to apply to options granted before July 2021, including qualifying options granted after June 2021 that replace options granted before July 2021. The proposed measures will not apply to stock options granted by CCPCs. In recognition of the fact that some non-CCPCs could be start-ups, emerging or scale-up companies, the proposed measures will generally not apply to stock options granted by non-CCPCs with an annual gross revenue of $500 million or less. For non-CCPCs that are part of a corporate group that prepares consolidated annual financial statements, gross revenue would be as reported in the most recent consolidated annual financial statements of the group presented to shareholders, or unitholders, prior to the date that the stock option is granted.

Employers subject to the new rules will be able to choose whether to grant employee stock options that are eligible for the security options deduction up to the $200,000 limit or to grant employee stock options that are not eligible at all for any security options deduction. An employer must notify its employees and the Canada Revenue Agency (CRA) if they choose to grant options on or after July 1, 2021, that are not eligible for the security options deduction.

Quebec provincial tax

For Quebec provincial tax, the security options deduction is generally only 25%. However, you may be eligible for a security options deduction of 50% for stock options granted under an agreement concluded after February 21, 2017, provided the shares are publically traded and the corporation is a "qualified corporation" at the time the stock option agreement is entered into or the shares are acquired. A "qualified corporation" is a corporation with a Quebec payroll of at least $10 million for that calendar year. Due to the two different deduction percentages in Quebec, it's important that you keep adequate records of when your stock options were granted and by which corporation.

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Quebec has not announced whether they will also introduce an annual $200,000 limit for the security options deduction.

An example for non-CCPC stock options

Charley, an employee at a large, mature Canadian public company, XYZ Co, is granted employee stock options to purchase 10,000 common shares of XYZ Co on January 1 of Year 1. The options vest after three years, i.e. January 1 of Year 4. The exercise price of the XYZ Co options is $25 per share, which is equal to the FMV of these shares at the time the options are granted. Charley's options vest in Year 4. He decides to exercise his options on June 25 of Year 4 when the shares are trading at $30 per share. On March 2 of Year 5, the share price increases to $32 per share and Charley decides to sell all his shares at that time.

Current rules (for options granted prior to July 1, 2021)

Charley has a $50,000 [($30 - $25) x 10,000] security options benefit to include on his income tax return for Year 4. Charley is entitled to a 50% security options deduction of $25,000 since the employee stock options are in respect of common shares and the exercise price ($25) was not less than the FMV of the shares ($25) at the time the options were granted. Charley is simply an employee and has no significant ownership in, or influence over, XYZ Co, so he and XYZ Co are dealing at arm's length. The net income inclusion on Charley's tax return for Year 4 will be $25,000 ($50,000 - $25,000).

Charley will also have to report a capital gain of $20,000 [($32 - $30) x 10,000] on his tax return for Year 5, half of which will be taxable.

Proposed rules (for options granted on or after July 1, 2021)

Charley has a $50,000 [($30 - $25) x 10,000] security options benefit to include on his income tax return for Year 4. Under the new rules, only 8,000 options will qualify for the 50% security options deduction ($200,000 limit divided by the FMV of the shares at the time the options were granted or $200,000/$25). Charley is therefore only entitled to a deduction of $20,000 calculated as follows:

($30 - $25) x 8,000 x 50% = $20,000

The net income inclusion on Charley's return for Year 4 will be $30,000 ($50,000 - $20,000).

Charley will also have to report a capital gain of $20,000 [($32 - $30) x 10,000] on his tax return for Year 5, half of which will be taxable.

Deferral of non-CCPC security options benefits exercised on or before March 4, 2010

You cannot defer the security options benefit on non-CCPC stock options exercised after March 4, 2010. However, if you exercised your non-CCPC stock options after February 27, 2000 but prior to 4 PM on March 4, 2010, it was possible for you to defer the taxation of the security options benefit, up to an annual limit, until you actually sold the shares or were deemed to dispose of the shares. You must have elected, in prescribed form, for the deferral to apply. The 50% security options deduction was also deferred until the security options benefit was taxable.

If you're still holding non-CCPC shares for which a deferral applies, you will need to include the security options benefit in income in the year you dispose of the shares or are deemed to dispose of them.

CCPCs

Employee stock options are taxed even more favourably if your employer company is a CCPC. There are two significant differences in the taxation of employee stock options of CCPC shares.

First, instead of realizing the security options benefit in the year you acquire the shares, the security options benefit is deferred until you dispose of the shares (or are deemed to have disposed of your shares).

Second, if you and your employer corporation were dealing at arm's length immediately after the stock option agreement was entered into, the security options deduction is available even if the exercise price was below the FMV of the shares at the time the options were granted, provided you held the shares for at least two years after exercising the options. There is no two-year holding requirement in the case of death.

Employee stock options are taxed even more favourably if your employer company is a CCPC.

However, if you did not hold the shares for at least two years, you may still be eligible for the security options deduction if the exercise price was at least equal to the FMV of the shares at the time the options were granted.

If a CCPC grants stock options to you and then ceases to be a CCPC (i.e. becomes a public corporation) before you exercise your options, the CCPC rules would still apply. A deferral of the security options benefit and a 50% security options deduction will still be available, if all of the other relevant criteria to be eligible for the deduction are met, as previously discussed.

An example for CCPC stock options

On March 30 of Year 1, Verna was granted employee stock options that gave her the right to acquire 100 shares of Diamonds Inc. for $5 per share. Diamonds Inc. is a CCPC. The FMV of the shares at the time of grant was $6 per share. Due to favourable drilling results, the share price increased to $20 per share by June 15 of Year 2. Verna decided to exercise her options at that time and acquired 100 Diamonds Inc. shares. On July 25 of Year 4, the shares of Diamonds Inc. were valued at $50 per share and Verna decided to sell her shares.

Since Diamonds Inc. is a CCPC, there were no immediate tax consequences to Verna on exercising her options. Verna only realized a security options benefit of $1,500 [($20 - $5) x 100] when she disposed of the shares in Year 4. Further, because Verna was dealing at arm's length with Diamonds Inc. and held her shares for more than two years (from June of Year 2 to July of Year 4), she is eligible for the 50% security options deduction of $750. After Verna exercises her options, the ACB of each share becomes the FMV at the time the option was exercised ($20). This ensures Verna is not subject to double taxation. Verna then realizes a capital gain of $3,000 ([$50 - $20] x 100) on the sale of the shares in Year 4.

In summary, on her tax return for Year 4, Verna will have an employment income inclusion of $1,500 and a corresponding deduction equal to half of the inclusion of $750. She will also recognize a capital gain in the amount of $3,000, half of which will be taxable.

Considerations upon exercising

Cash-out of stock options

Where your employer provides you with the option to receive cash instead of securities upon exercising your

options, and you choose to receive the cash, either your employer can claim a deduction for the cash paid or you can claim the 50% security options deduction if eligible, but not both. If your employer chooses not to claim the cash-out as a deduction, they will need to file an election with the CRA to forgo the deduction. Your employer will need to provide you with written evidence of filing the election in order for you to claim the security options deduction.

A cash-out of your stock options should not be confused with a cashless exercise of your stock options, where you actually acquire the shares but then sell them immediately.

Cashless exercise of stock options

If you've been granted employee stock options but do not have the cash needed to pay for the shares upon exercise of the options, you can consider a cashless exercise of your options. A cashless exercise involves short selling the underlying shares as a means of acquiring the cash needed to exercise the options. Generally, short selling is a speculative practice that involves using a broker to sell shares you do not own.

Using some of the funds raised from the short sale, you exercise your stock options. The broker receives the shares from your employer and uses them to cover the short sale. The broker then pays you the difference between the cash received from the short sale and the cash used to exercise your stock options.

The risk of a cashless exercise is that the price of the underlying shares may change from the time of the short sale to the time you receive the shares from your employer. The FMV of the shares on the date you give notice that you intend to do a cashless exercise is the value used to calculate your security options benefit and determine the ACB of your shares. If the value on the date you give notice is different from the value received on the short sale, then you'll have a gain or loss.

For tax purposes, the CRA generally considers a gain or loss resulting from a short sale to be an income gain or loss (i.e. 100% taxable or deductible) and not a capital gain or loss (i.e. 50% taxable or deductible). However, there are circumstances in which the gains or losses from a short sale can be treated as a capital transaction. You should consult with a qualified tax advisor to determine how any gain or loss on a cashless exercise of your stock options should be classified. You should also check with your RBC advisor to determine if you meet the requirements to execute a cashless exercise.

Withholding tax on the security options benefit

Since you receive a security options benefit as part of your remuneration, the benefit is considered employment

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income. Therefore, your employer is required to withhold and remit the appropriate source deductions to the CRA at the time you exercise your options (except in the case of a CCPC). Your employer will generally withhold on the security options benefit, net of the security options deduction, where applicable. Your employer is also required to withhold in the event you choose to do a cash-out or cashless exercise of your options.

There are different methods for funding the withholding tax requirements. For example:

- Your employee stock option plan may require that you remit sufficient funds to your employer to cover the withholding tax.
- Your employer may make extra withholdings from your regular salary or bonus.
- Your employer may pay the tax required on your behalf and require that you reimburse them.
- Your employer may require a broker to sell a certain number of the shares issued to you in order to fund the withholding requirement. There would need to be a liquid market for the shares to do this.

Foreign exchange

If you exercise an option that's denominated in a foreign currency, such as U.S. dollars, the appropriate date to quantify the security options benefit is the exercise date. You will need to convert both the FMV of the shares at the time you exercise the options and the amount you pay for the shares (the exercise price) into Canadian dollars using the exchange rate on the date you exercised the options.

Contributions to your registered plans

Contribution of stock options to your TFSA

You can contribute stock options to your TFSA, as long as the underlying securities are qualified investments for TFSA purposes. The options must be contributed at its FMV (resulting in a capital gain assuming you did not pay to acquire the options) and the contribution is subject to your unused TFSA contribution room. As such, you will have to determine the FMV of the options contributed.

The CRA used to view the intrinsic value of an option (that is, the amount by which the current market price of

the share exceeds the exercise price) as reflective of the option's FMV but has since changed their view. Where an option is "out of the money" and the exercise price to acquire the share is actually greater than the share's FMV, the intrinsic value of the option suggests no value, or even a negative value. However, the option may still have a value. It's the CRA's current view that instead of using the intrinsic value, "a valuation method appropriate in the circumstances" should be used to determine the FMV of an option.

Although you don't have a security options benefit at the time you contribute the options to your TFSA, you do have a security options benefit at the time you exercise the options in your TFSA (for both non-CCPC shares and CCPC shares). You may claim the 50% security options deduction, if all of the relevant conditions are met. If the options expire in your TFSA, you will not have a security options benefit.

While the income tax legislation lists the types of qualified investments for a TFSA, financial institutions issuing TFSAs can have internal policies which limit the type of qualified investments that can be held in the TFSAs they issue. If you're considering contributing employee stock options to your TFSA, check with your financial institution to see if they have any additional restrictions.

Contribution of stock options to your RRSP

You can also contribute stock options to your RRSP, as long as the underlying securities are qualified investments for RRSP purposes. The amount of the contribution is the FMV of the options at the time of contribution (resulting in a capital gain assuming you did not pay to acquire the option) and is subject to your unused RRSP contribution room. However, the main issue with contributing stock options to your RRSP is the potential for double taxation. You have an income inclusion when the options are exercised inside your RRSP (for both non-CCPC shares and CCPC shares). In addition, when you ultimately withdraw the funds from your RRSP, the full amount of the withdrawal is taxable to you at your marginal tax rate. You are essentially double taxed on the amount of the security options benefit. If you qualify for the security options deduction, you may claim it at the time you exercise your options.

Another problem may arise when you exercise the stock options within your RRSP, since employers are required to withhold tax at the time of exercise. Some of your shares issued on the exercise of your stock options may have to be sold to cover the withholding tax. This would result in an income inclusion for you, taxable at your marginal tax rate. The transaction is treated as if you withdrew the amount from your RRSP to pay the tax liability arising on the exercise of the stock options held in your RRSP. To avoid this issue, it may be possible for your employer to satisfy the withholding requirements using another method, for example, by making extra withholdings from your regular salary or bonus.

You can also contribute stock options to your RRSP, as long as the underlying securities are qualified investments for RRSP purposes.

Although it's generally not advisable to contribute your employee stock options to your RRSP, if you're considering it, it's important to discuss with your employer how they intend to satisfy the future withholding tax requirements. It's also important to discuss with a qualified tax advisor whether it makes sense for you from a planning perspective. Lastly, be sure to check with your financial institution whether they have any additional restrictions with respect to contributing employee stock options to your RRSP.

The disposition of your shares

When you dispose of your shares acquired under a stock option agreement, this triggers tax implications and you have to consider various rules, which are discussed in the following sections. Although a disposition can occur when you sell your shares on the market, it can also occur when you transfer your shares to a registered plan, to most trusts or to another individual, including your spouse. If you transfer your shares to a corporation, even if you do so on a rollover basis, it may also be considered a disposition for tax purposes. Besides the actual disposition of your shares, there are situations where you might be deemed to have disposed of your shares, including on death and on becoming a non-resident.

The ACB rules

In the year you dispose of your stock option shares, you'll need to calculate and report the capital gain or loss, which will be based on the proceeds you receive less the ACB of your shares. Several rules apply when determining the ACB of your stock option shares. For example, when you exercise the stock options, the security options benefit is normally added to the ACB of your newly acquired shares so that the ACB will generally be the FMV of the shares at the time of exercise.

There is another general averaging rule that states shares of the same class of capital stock are considered identical properties, and the ACB of identical properties needs to be averaged amongst all of the identical properties you hold at that time. So, when you exercise stock options to

acquire shares but you already own other shares of your employer company, the ACB of all identical shares will generally have to be averaged amongst all of the shares you own.

However, the normal ACB averaging rule does not apply to securities acquired after February 27, 2000, under a stock option agreement where:

1) The security options benefit is deferred (in the case of CCPC shares or pre-March 4, 2010 non-CCPC shares subject to a deferral); or

2) The shares acquired are designated and disposed of within 30 days of acquiring them, provided you do not acquire or dispose of any other identical shares during this period.

Instead, each of these securities has their own ACB and you do not need to average the ACB of these shares with any other identical shares held.

Identical properties

The CRA has stated that "identical properties are properties which are the same in all material respects, so that a prospective buyer would not have a preference for one as opposed to another".

Determining whether properties are identical is a question of fact and must be decided based on the details in each situation. Generally, shares of the same class of capital stock are considered identical properties. On the other hand, two different classes of shares of a corporation should not be considered identical if they do not have the same interests, rights and privileges.

The order of disposition rules

When you sell your shares acquired under a stock option agreement, there are rules which determine the order of disposition. The rules make a distinction between securities for which you have deferred the security options benefit ("deferral securities") and those for which you have not ("non-deferral securities"). Note that for these rules, the deferral securities only relate to CCPC shares for which you've deferred the security options benefit and do not include non-CCPC shares, even if you've deferred the security options benefit upon acquiring them (on or before March 4, 2010).

First, if you have securities which are considered identical properties, you're deemed to dispose of them in the order in which you acquired them (first in first out). For this purpose, you're deemed to have acquired non-deferral

When you sell your shares acquired under a stock option agreement, there are rules which determine the order of disposition.

securities before deferral securities. This allows you to continue deferring the security options benefit where you have not disposed of all your securities. Where you acquire identical deferral securities at the same time, you're considered to have acquired them in the order in which the options were granted.

An example on the disposition of your shares

Frank worked for GRT Inc. (a CCPC), and as part of his compensation package, he was granted two employee stock options. The first employee stock option was granted on September 1 of Year 1 and the other on December 1 of Year 1, both with an exercise price of $10 and a vesting period of 2 years.

On September 15 of Year 3, Frank was able to exercise his first employee stock option (granted on September 1 of Year 1) and acquired one share of GRT Inc. The FMV of the share was $20 which then became the share's ACB. Frank deferred the security options benefit of $10 ($20 - $10). Since Frank deferred the benefit, the ACB of this share is excluded from the cost averaging rule and the share is not deemed to be identical to any other share he might own in the future. The ACB of this share remained at $20.

On December 15 of Year 3, Frank exercised his second employee stock option (granted on December 1 of Year 1) and acquired one additional share of GRT Inc. The FMV of the share was $30. Frank again deferred the security options benefit of $20 ($30 - $10). Since Frank deferred the benefit, the ACB of this share is excluded from the cost averaging rule and the share is not deemed to be identical to any other share he owns. The ACB of this share remained at $30.

On March 1 of Year 4, GRT Inc. went public. Frank thought GRT Inc. was an excellent company to work for and wanted to benefit from the future growth of the company. So on March 1 of Year 4, he purchased 10 shares of GRT Inc. on the exchange for $40 per share. The next month, on April 1 of Year 4, Frank purchased 10 additional shares of GRT Inc. on the exchange for $50 per share. Since these 20 shares are considered identical properties for the ACB averaging rule, the ACB of all of these shares will need to be averaged so the average cost per share is $45 ([(10 shares x $40) + (10 shares x $50)]/20 shares).

Frank now had three groups of shares (and owned a total of 22 shares):

1) One deferral share acquired in September of Year 3 with an ACB of $20 and a deferred security options benefit of $10;

2) One deferral share acquired in December of Year 3 with an ACB of $30 and a deferred security options benefit of $20; and

3) 20 non-deferral shares acquired in March and April of Year 4 with an ACB of $45 per share.

On January 1 of Year 5, Frank sold 20 shares of GRT Inc. for $115 a share. Since Frank holds some deferral securities and some non-deferral securities, he is considered to first dispose of his non-deferral securities. Frank realized a capital gain of $1,400 [($115 - $45) x 20 shares] on the disposition of his non-deferral shares.

On February 1 of Year 5, Frank decides to sell one more share of GRT Inc. for $120. Since Frank is deemed to dispose of the remaining two securities in the order in which he acquired them, Frank realized a capital gain of $110 [$120 - $10] on his deferral share acquired in September of Year 3. In addition, since Frank disposed of one of his deferral shares, he also has to recognize the deferred security options benefit of $10 in his income for that year (less the security options deduction of $5, if applicable).

Frank continues to hold the remaining GRT Inc. share with the intention of selling it at the end of Year 5.

Non-residents

When you cease Canadian residency, you're generally deemed to dispose of certain non-registered assets on the date you officially become a non-resident of Canada for tax purposes. An exception to this rule exists for employee stock options. If you own employee stock options and subsequently become a non-resident of Canada, you're not considered to have disposed of your options.

Holding unexercised options

If you exercise these employee stock options as a non-resident, you will be taxable in Canada on the security options benefit in the year you exercise the options. If you were granted the stock options for CCPC shares, then you can defer the security options benefit until you actually dispose of the shares. You may be able to claim the security options deductions in the year you recognize the benefit, if all the relevant criteria were met.

Even if you're a non-resident, you are taxable in Canada on the security options benefit because your employment for which the stock options were granted was performed in Canada. You will have to file a Canadian tax return to report the security options benefit as employment income and pay the taxes owing. Certain tax treaties between Canada and your current country of residence may allow for the security options benefit not to be taxed in Canada, so you should confirm your specific tax implications with a qualified cross-border tax professional.

Holding shares

If you've already exercised your options and cease Canadian residency while holding shares, you will be deemed to have disposed of the shares, resulting in a capital gain or loss. In the case of CCPC shares, you can still defer the security options benefit until you actually dispose of your CCPC shares. Note that this is not the case for options exercised on or before March 4, 2010, for non-CCPC shares. If you were able to defer the security options benefit at the time of exercise under the rules that existed prior to March 4, 2010, for non-CCPC shares, you'll have a security options benefit at the time you become a non-resident.

Since the departure tax rules are complex, you should consult with a qualified cross-border tax professional if you're considering moving from Canada to another country.

Alternative minimum tax (AMT)

If you've claimed a security options deduction, you may be subject to AMT. AMT is an alternative method used to calculate your taxes owing and is the federal government's attempt to limit the tax advantage you can receive from claiming certain tax deductions. The security options deduction is one of those deductions, so you should always consider AMT when claiming a security options deduction. A qualified tax advisor can assist you with this analysis.

Donation of employee stock option shares

Assuming you qualify for the 50% security options deduction, you may receive an additional deduction, if you donate your publicly listed stock option shares to a qualified donee. A qualified donee is an organization that can issue official donation receipts for the gifts it receives. Typically, a qualified donee includes a registered charity which can be a charitable organization, a public foundation or a private foundation.

However, you will not qualify for the additional deduction if you donate publicly listed stock option shares that were not eligible for the security options deduction under the proposed measures.

When you cease Canadian residency, you're generally deemed to dispose of certain non-registered assets on the date you officially become a non-resident of Canada for tax purposes. An exception to this rule exists for employee stock options.

In order to qualify for the additional deduction, you will need to donate the shares acquired on the exercise of your options in the same year you exercise the options and within 30 days of exercising the options. If you exercise your stock options in December, you will not have the full 30 days to make the donation, as you must donate the shares before December 31.

The amount of the additional deduction is generally equal to 50% of your security options benefit, effectively eliminating the tax on your security options benefit. If you live in Quebec, on your Quebec provincial income tax return you will receive the additional 50% deduction on top of your regular security options deduction, which may be 25% or 50%.

If the shares decline in value so that the FMV of the shares at the time you donate them in-kind is less than the FMV of the shares at the time you exercised the options, your additional deduction is reduced proportionately. In other words, your additional deduction will be less than 50% of your security options benefit.

In addition to eliminating or reducing your security options benefit, you will also receive a donation tax receipt equal to the FMV of the shares you donate. This allows you to claim a donation tax credit which can be used to reduce the taxes payable on your other sources of taxable income.

In a cashless exercise, if you direct the broker to immediately donate all or a portion of the proceeds to a qualified donee, you will still be eligible for a portion of the additional deduction. The deduction is prorated to reflect the proportion of the proceeds that you instruct the broker to donate.

For a more detailed discussion of the advantages of gifting public company shares to a qualified donee, please ask your RBC advisor for the article on the donation of shares acquired on the exercise of employee stock options.

Taxation of employee stock options on death

Holding shares

If you pass away, and at that time you hold shares acquired under an employee stock option agreement where the security options benefit has been deferred, you will be deemed to have disposed of your shares. Your legal representative will have to include the previously deferred security options benefit on your terminal tax return. If the conditions are met for claiming the security options deduction, then your legal representative will be able to claim the 50% security options deduction on your terminal return. For CCPC shares, if you die before the two-year holding period, the 50% security options deduction may still be claimed on your terminal return.

If you pass away, and at that time you hold shares acquired under an employee stock option agreement where the security options benefit has been deferred, you will be deemed to have disposed of your shares.

Holding unexercised options

If you have unexercised stock options at the time of death, you will be deemed to have a security options benefit in the year of death. The benefit is equal to the FMV of the stock options immediately after your death less any amount you paid to acquire those options. This benefit will need to be reported on your final return.

Where the terms of the stock option plan provide that the options are automatically cancelled upon death, the value of the options immediately after death will be nil, resulting in no security options benefit being included on your terminal return. In the case where your stock options do not vest prior to your death, you would not own the options prior to your death and, again, you would not have a security options benefit on your terminal return.

Sometimes, the terms of the stock option plan provide that the options may be exercised for a limited time period after your death. If the stock options are exercised within the first taxation year of your graduated rate estate (GRE), by your GRE, a person who's a beneficiary of your GRE, or a person in whom the rights under the stock option agreement have vested, then the legal representative of your estate may claim the 50% security options deductions on your final return, if all of the other relevant criteria are met.

In the case where your options are exercised and cash is received instead of shares (a cash-out), then your legal representative can claim the 50% security options deduction on your final return, provided your employer files a prescribed election with the CRA to forgo the deduction and provides evidence in writing of the election to your GRE.

If, within the first taxation year of your GRE, your options are exercised, disposed of or expire, and the value of the options has declined since your death, the benefit actually realized by your GRE may be less than the security options benefit deemed to be realized on your terminal return. In this case, if the legal representative administering your GRE elects in a prescribed manner, an amount that's deemed to be an employment loss can be carried back to your terminal return to reduce the security options benefit originally reported.

U.S. estate tax considerations

Stock options to acquire shares of U.S. corporations are considered U.S. situs assets. The value of these options would be included in determining whether you're subject to U.S. estate tax and the amount of U.S. estate tax you have to pay. Of course, if you're a U.S. person and the value of your worldwide assets is above the estate tax thresholds, you would be subject to U.S. estate tax regardless of whether your assets are U.S. situs or not.

Tax implications on death can be very complex and, in such situations, your legal representative should consult with a qualified tax advisor.

Conclusion

For many years, companies have been offering employee stock options to their employees as part of their compensation plan. Stock options offer you, as an employee, an opportunity to have ownership in the company you work for and feel more connected to the business. They can be part of your long-term financial strategy, allowing you to reap the rewards of a successful business in the form of dividend income or capital appreciation. Alternatively, they can provide you with additional compensation from employment, which is taxed more favourably than a salary or bonus. There are many possible tax advantages to receiving employee stock options, but due to the complexity of the tax rules, it's always recommended that you consult with a qualified tax advisor about the tax implications to you.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

Wealth Management

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