

ADVISORY LETTER CONCERNING EMPLOYEE STOCK OPTIONS

Over the last couple of years one of the major advocacy issues that CATA Alliance has pursued has been an improvement in the tax treatment of employee stock options. The federal government has tried to deal with this issue by introducing a number of changes in the February 2000 budget. Unfortunately the changes implemented in last year's budget, although conceptually correct, do not function adequately. Thus, in some situations a tax liability can be incurred by an employee even though no real benefit has accrued to the employee as a result of exercising his/her stock option. Consequently, CATA Alliance is continuing to pursue this issue with the Department of Finance.

In the meantime, we would like to take this opportunity to draw your attention to the risk associated with the timing of the exercise of an employee stock option. As such, we would like to focus on the scenario where: i) a tax liability was incurred by the employee when the stock option was exercised -- i.e., a taxable benefit was deemed to have occurred since the option price was lower than the market price of the shares at the time the option was exercised and no deferral was available; and, ii) after the stock option was exercised the market price of the stock fell below the option price. Note that under this scenario employees have incurred a tax liability on the paper gain¹ realized at the time the stock is exercised, irrespective of whether or not there is a real monetary gain on the value of the stock (versus the option price) at the time when the stock is sold, or deemed to be sold.

In summary, the employee may actually be out-of-pocket as a result of his/her decision to exercise the stock option - since he/she may incur a tax liability (related to the paper gain incurred when the stock option is exercised) even if no real monetary gain is realized when the stock is sold.

Since many employees are not aware of the risks associated with the above-mentioned scenario, some employees may not have set aside the funds to cover the tax liability incurred and therefore may face liquidity/cash flow problems. Note that under certain circumstances where there is a 'deemed disposition' of the employee's stock (i.e., at the employee's death, etc.) the employee's estate and heirs would be forced pay any outstanding tax liability pertaining to the stock option's 'paper gain'.

You may want to advise your employees of the risks.

The attached newsletter, provided by Earl Viner (KPMG National Practice Leader, Research and Development) discusses employee stock options in detail.

Note that both CATA Alliance and KPMG strongly recommend that the information contained in this letter and newsletter should be reviewed and discussed with your financial and legal advisors before you take action on any of the information contained here-in.

Note: Another CATAAlliance Tax Advocacy Issue

CATAAlliance is the leading advocate for improvements to Canada's SR&ED tax credit program. The result has been the commitment of the federal government to a major overhaul of the program's management. As part of our work to promote improvements, CATAAlliance also monitors the opinion of the community on how well the SR&ED program is working; last year, we produced a first report card on the program. The methodology has been transferred to CCRA to become the basis for an expanded ongoing monitor.

++ Action Requested: Complete Survey

CATAAlliance is conducting a simplified on-line follow up survey to determine where you think we have arrived, and how we should be focusing our advocacy. The greater the industry response, the more leverage we have in influencing change. **Please have your CFO (or executive responsible for SR&ED claims), take five minutes to complete the survey. Point your browser to www.cata.ca/cata/advocacy/sred1.cfm**

Note that we are also completing advisories on critical tax and finance subjects as part of CATAAlliance member services. We hope that you will find them useful. If you have questions, please log onto our Assistance Line at www.cata.ca/cata/advocacy/members/assistance.cfm

¹ i.e., the difference between the option price and market price of the share at the time the option was exercised.

New Tax Rules Raise the Stock of Employee Options in Public Company Shares

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The 2000 federal budget proposed significant tax breaks for employees who exercise stock options in shares of qualifying public companies, but, until now, the precise mechanics of the proposals had not been released. Recently-issued draft legislation fills in the details of the incentive and offers greater certainty for employees and employers for maximizing the incentive's benefits.

If you are an employee holding stock options in your employer, an understanding of the new rules will help ensure you make the most of the related opportunities.

And if you are an employer seeking ways to attract and retain skilled employees in today's heated labour market, particularly in the high technology sector, employee stock option plans are an increasingly popular route.

The rules governing the taxation of employee stock options are complex and may trigger unintended tax consequences to employees if plans are not properly designed. This *Canadian Tax Letter* summarizes the new rules for options in public company shares and features some planning ideas for gaining maximum benefits from this incentive. For a more general discussion of employee stock option plans, see KPMG's *Tax Planning for You and Your Family*, now available in bookstores across Canada.

New Rules for Stock Options in Public Companies

A stock option plan is an arrangement whereby a corporation gives an employee the right (an option) to invest in its shares at a given price. The price may or may not be less than the market price at the time the option is granted. Recognizing the increasing importance of these



Tax Deferral Offers New Planning Opportunities

New rules permit employees to defer the taxation on \$100,000 per year of qualifying employee stock options for publicly-listed shares. The following ideas are among those discussed in this *Canadian Tax Letter* for making the most of this incentive.

Opportunities for employers:

- Be aware of the effect of the vesting period of options on the employee's ability to defer the taxable benefit — for options with a fair market value over \$100,000 it will generally be advantageous to spread the vesting period over two or more years.
- Consider cash payments in lieu of shares to offer employees the same value of compensation while allowing the employer to deduct the full amount on the incentive payment.

Opportunities for employees:

- Employees must complete an election form by February 15, 2001 to defer tax on qualifying shares acquired in 2000.
- Avoid the negative effects of cost base averaging on newly-acquired employer-company shares by making the special designation for option shares sold within 30 days of their acquisition.
- If you are thinking about donating cash to charity, think about donating public company shares acquired under a stock option plan instead.

plans for recruiting and retaining key employees, the 2000 federal budget proposed to postpone the taxation on \$100,000 per year of qualifying employee stock options for publicly-listed shares.

Under the current rules...

Under the existing rules, you are generally considered to receive a benefit from employment in the year you exercise an employee stock option. The taxable benefit is the difference between the fair market value of the shares at the time you exercise the option and the actual cost of the shares (i.e., the exercise price).

You can then claim a deduction to offset the benefit if:

- the shares are normal common shares (not preferred shares)
- the exercise price is not less than the fair market value of the shares at the time the option was granted
- you deal at arm’s length with the corporation.

If each of these conditions is met, you can deduct one-half of the amount of the taxable benefit (one-third for options exercised from February 28 – October 17, 2000; one-quarter for options exercised before February 28,

2000). The effect of this deduction is to tax the employment benefit at the same inclusion rate as a capital gain.

When you sell the shares, the sale may trigger a capital gain or loss if the proceeds you receive are greater or less than the cost of the shares. For purposes of calculating cost, the amount of the stock option benefit that you have included in your income is added to the actual cost of the shares.

As a result, a capital gain or loss will not arise if you exercise the shares and immediately sell them since the actual cost of the shares plus the benefit will equal their fair market value. But if you hold the shares instead, a capital gain or loss will only accrue on the shares from the date of exercise to the date of sale.

Under the new regime...

If you exercise an employee stock option for publicly-listed shares and you do not sell the shares, the same benefit arises under the new rules but you can elect to defer the benefit’s taxation until the year you sell the shares. At that time, you can claim the 50% employee stock option deduction to partially offset the inclusion of the benefit in your income.

The tax results under the scenarios described above are summarized in the chart below.

Event	Tax result to employee	Amount included in employee’s income
Stock option granted	None	None
Option exercised and shares are immediately sold	<ul style="list-style-type: none"> • Employment benefit, subject to 50% employee stock option deduction • Amount of benefit is added to cost of shares • Taxable capital gain or loss should be nil 	<ul style="list-style-type: none"> • [Fair market value of shares on date acquired less exercise price of the options] × 50%
Option exercised and shares kept; employee elects to defer the benefit	<ul style="list-style-type: none"> • Employment benefit, subject to 50% employee stock option deduction, is calculated but not included in income until year of sale • Amount is reported on employee’s T4 slip as a deferred benefit • Amount of benefit is added to cost of shares 	None
Shares on which deferral election is made are sold in a later year	<ul style="list-style-type: none"> • Inclusion of deferred employment benefit, subject to 50% employee stock option deduction, and • Taxable capital gain or loss 	<ul style="list-style-type: none"> • [Fair market value of shares on date acquired less exercise price of the options] × 50%, and • [Sale proceeds less cost of shares] × 50% capital gains inclusion rate

Who Qualifies for the Deferral?

Employees must meet several conditions to qualify for the tax deferral on publicly-listed shares acquired under qualifying employee stock options. Among other things, you must be a resident of Canada, you must deal at arm's length with your employer and you must not be a "specified shareholder" (i.e., generally, you must not own more than 10% of the company's shares).

Additionally, the total of all amounts payable to acquire the shares, including the option price and any amount payable to acquire the option, cannot be less than the share's fair market value on the date the option was granted. If these conditions are met, the stock option benefit on the qualifying stock options can be included in income in the year that the shares are sold, subject to the annual vesting limit.

\$100,000 Annual Vesting Limit

The \$100,000 annual limit is based on the fair market value of the shares on the date that the option is granted. As well, this limit applies to the year of vesting—the year the employee gains the right to exercise the options under the terms of the option agreement—and not to the year in which the option is granted or exercised. As a result, the vesting period can dramatically change the amount of the benefit that may be deferred.

For example, say an employee is granted options for 20,000 shares with an exercise price of \$10 per share (\$200,000 in total), which is their fair market value at the time the options are granted. All of the options vest in Year 1 and the employee exercises the options in that year when the share price is \$25 per share (\$500,000 in total).

In this case, the employee's potential benefit is \$300,000 (\$500,000 – \$200,000). But the deferral is only available for 10,000 shares due to the \$100,000 limit, so only half of the total benefit (\$150,000) can be deferred. The additional \$150,000 will be taxed under the general rules as employment income in Year 1 (subject to the employee stock option deduction, if applicable).

But what if we change the facts so the vesting period for the 20,000 shares is spread equally over Years 1 and 2 (i.e., 10,000 each year) and the employee exercises the options in Year 2? In this case, tax on the entire \$300,000 benefit can be deferred because the fair market value of the 10,000 shares attributable to options vesting each year does not exceed the \$100,000 annual limit.

Tracking the annual vesting limit

Under the terms of the draft legislation, it is the employee's responsibility to ensure that the \$100,000 limit is complied with when the deferral election is made (see below). The employee has only one \$100,000 limit for each vesting year.

Reporting and Withholding

Making the deferral election

Employees wishing to take advantage of the deferral for qualifying shares acquired in 2000 must make an election with the employer or another of the parties responsible for reporting the deferred stock option benefit on or before February 15, 2001. Although a prescribed form for the election may eventually be available, for qualifying shares acquired in 2000, the election must be in the form of a letter from the employee to the employer containing:

- a request for the deferral provisions to apply
- the amount of the stock option benefit, related to qualifying shares acquired after February 27, 2000, being deferred
- confirmation that the employee was resident in Canada when the shares were acquired
- confirmation that the \$100,000 annual vesting limit has not been exceeded.

For 2001 and later years, the deadline for the election will be January 15 of the year following the year in which the share is acquired. The election must be kept on file by the employer.

Reporting obligations—Employees

Employees with deferred stock option benefits must file Form T1212, Statement of Deferred Stock Option Benefits, with their tax returns each year, starting with 2000 tax returns. On the form you must report certain information about the acquisition and disposition of stock option shares.

Reporting obligations—Employers

Generally, employers are required to report deferred stock option benefits on employees' T4 slips each year. If the employer, the corporation granting the option and the corporation whose shares are acquired by a taxpayer under the option are not the same entities, each is jointly liable for reporting the deferred benefit. However, reporting by one fulfills the reporting obligations of all, allowing all parties involved to determine who is best able to report the deferred benefit.

Employers have no obligation to withhold or remit tax in respect of the employment benefit recognized on the disposition of shares by employees who previously elected to claim the deferral. However, employees will still be required to include the benefit in income and pay the tax when they file their returns. As such, employers may wish to offer withholding at the employee's request.

Revoking a deferral election

In some cases, an employee may wish to revoke a deferral election made before the election deadline for that year in order to reinstate all or a portion of the \$100,000 annual vesting limit. To do so, the employee must file written notification to this effect with the person with whom the election was filed.

For shares acquired in 2000, the election deadline is 60 days after the legislation to enact these measures receives Royal Assent. For later years, the deadline is January 15 of the year following the year in which the shares were acquired.

Special Rules and Related Planning Opportunities**Cost base of identical shares—30-day designation rule**

As noted, the cost base of shares acquired through stock options equals the sum of the option price plus the amount of the taxable employment benefit.

But how is the cost base calculated if an employee acquires employer-company shares under a stock option plan and he or she already holds other employer-company shares? Generally, the cost base is calculated as an average of all the shares by adding together their cost base amounts and dividing the result by the total number of shares.

But in cases where you already own shares and you acquire new shares and immediately sell them, this cost base averaging may create a higher or lower capital gain if there is a significant difference between the tax cost of the two pools of shares. To avoid this result, a special rule now gives you the option to designate the new stock option shares as the particular shares being sold so that the averaging rules will not apply.

To qualify for this special rule, you must have acquired the new shares under an option agreement and you must dispose of them within 30 days after the option is exercised. As well, you must not acquire or dispose of any other identical shares from the date of exercise to the date of the sale.

Identical shares—Order of sale

Generally, you are deemed to dispose of identical stock option shares in the order in which you acquire them. But, in some cases, you may acquire shares by exercising more than one option at the same time. If you only sell some of these shares, how do you know which shares were acquired first? The draft law provides ordering rules for making this determination.

If you elect to defer the stock option benefit related to qualifying shares and you hold other, identical shares that are not subject to the deferral, the draft rules deem you to have sold the non-deferral shares first, thus ensuring that your deferral can continue until all non-deferral shares are sold.

In other cases, you may acquire a number of identical shares all subject to the deferral but relating to different option agreements at the same time. If so, you are deemed to have acquired the shares in the order the options were granted. As a result, when you sell some of the shares they are deemed to be sold in the order the relevant options were granted.

Donating shares acquired through employee stock options

If an employee donates public company shares acquired under a stock option plan to a registered charity (other than a private foundation), an additional deduction is available that effectively reduces the related income inclusion to one-quarter of the employee stock option benefit (one-third in the February 28 to October 17 period), the same inclusion rate that would apply to a capital gain realized on the donation of other shares. To qualify, you must acquire the shares after February 27, 2000 and before 2002 and make the donation within 30 days of the share acquisition.

For more information on this topic, see our January 2001 *Canadian Tax Letter*, “Tax Incentives for Charitable Donations—Making the Most of Your Gifts”, available from your KPMG adviser or via our web site at www.kpmg.ca.

Replacement shares issued on reorganizations

Under the draft legislation, the deferral will continue where replacement shares are issued in a qualifying exchange in the course of a corporate merger, spin-off or other reorganization, providing the shareholder receives no other consideration on the exchange.

Emigration or death

If the employee ceases Canadian residency, he or she will be required to recognize the benefit on any amounts deferred under these proposals at that time. The deferral also ceases on the death of an employee and the employee’s estate becomes liable for payment of the tax.

Beware of capital losses

In cases where an employee acquires shares under a stock option arrangement and does not immediately sell them, the results may be severe if the value of the shares declines after acquisition. The employee will still be liable for tax on the difference between the exercise price and the share value at acquisition, even though no real monetary gain is realized when the stock is sold.

Further, the capital loss triggered on the sale cannot offset the employment benefit included in income. Despite the loss in value, tax on the benefit is still payable.

Consider Cash Payments in lieu of Shares

The terms of some stock option plans allow employees to receive a cash payment equal to the value of the options instead of shares. Where the plan allows the employee to make the choice, the same tax consequences apply to the cash payment as would apply to the issuance of shares — the employment benefit is included in income and the related 50% deduction is available if the required conditions are met.

But with a cash payment, the employer corporation may be better off because it can deduct the payment the same way as regular salary compensation and reduce its taxable income. No such deduction is allowed where a corporation issues shares to its employees under the terms of a stock option agreement. Of course, the cash payment will be treated as an expense and reduce income on the company’s financial statement.

Summary

Beyond the tax benefits, share ownership plans can offer flexibility in developing attractive remuneration packages, while at the same time motivating employees and fostering their long-term commitment to your company. But you need to consider the related tax issues to achieve your desired results.



Canadian Tax Letter

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CATA Alliance is the leading advocate for improvements to Canada's SR&ED tax credit program. The result has been the commitment of the federal government to a major overhaul of the program's management. CATA's work has been led by Russ Roberts, CATA's Senior Policy Director, who CATA retained to strengthen their advocacy in this policy area. A recent submission, prepared under Mr. Roberts' direction, is a case in point. Refer to www.cata.ca/cata/advocacy/sred_internalsoft.cfm for a copy of "Continued Inclusion of Internal Software in the SR&ED Program."