

# Stock Option Tax Issue

CFET

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# Canadians for Fair and Equitable Taxation (CFET)

- A growing group of hard-working Canadians who have seen their lives deeply impacted and their life savings destroyed as a result of an issue in tax law
- Representative of 1000s of Canadians in the same situation
- Press Conference held in the Parliament press theatre on Feb 21.
- Ongoing activity to raise visibility with politicians and press
- [www.cfet.ca](http://www.cfet.ca), [inquiry@cfet.ca](mailto:inquiry@cfet.ca)

# The Tax Issue

- Paper gains on shares acquired from an employee stock option or stock purchase plan are treated as employment income.
- Subsequent real losses on these same shares is treated as a Capital loss
- Since Capital loss cannot be used to offset employment income, people are left with a huge tax bill on money they never made, a.k.a phantom income
- This has devastated people's savings, home ownership and lives
- Canada is rare amongst industrialized countries to assess taxes on paper profits from stock options/employee purchase plans

# The Tax issue – An example

- An employee is granted stock options at \$15
- He exercises them when the stock is at \$115 and holds the shares. He is assessed an employment gain on \$100
- The stock crashes back to \$15, at which point he sells. He is assessed a capital loss of \$100
- He can't use the capital loss against the employment gain so, he is taxed on \$100 he never really made.
- For 2,000 stock options (not a huge number in the .com days), this is a tax on \$200K that the person only ever had on paper

# The Tax issue – two employees

- Granted options at \$15
  - Stock rises to \$115
  - Exercises and holds stock. Incurs \$100 employment gain
  - Stock crashes back to \$30
  - Sells. Incurs \$70 capital loss but can't use it against employment gain
  - Taxed on \$100. For 10,000 shares the tax is on a million dollars the person never received
- Granted Options at \$15
  - Stock rises to \$115
  - Does not exercise and Continues to hold options
  - Stock crashes back to \$30
  - Sells. Incurs \$15 employment gain
  - Taxed on \$15. For 10,000 options this is tax on \$150K he actually received

**Same company, same stock, same risk of loss or gain,  
Why different taxation?**

# Deferral provisions - the sword of Damocles

- Provisions passed in the 2000 budget allowed some tax to be deferred until stock is sold.
- Because of the way the provision was described, people thought they would pay tax on what they actually earned when the stock was sold so many held the stock to avoid their options expiring
- In reality, like before, tax is owed on the value of the stock at exercise time not on at sale time
- Selling, however, is not always at the option of the stock owner but could be forced as a result of a company sale or bankruptcy
- For Example, if Nortel were to be acquired in a private equity deal (Like Teacher's acquiring BCE), this would be treated as a sale
- Such a sale would immediately trigger huge tax liability for many people

# The Tax issue – Some Impacts

- JB – Age 55 – JDSU
  - \$14/hr assembly worker. Purchased stock via employee plan. Received a \$50K tax bill and CRA threatened to foreclose the family home (paid by husband but in both their name. Took bank loan to pay tax and it will take years to repay the loan
- RV – Age 45 – Entrust
  - Assessed \$80K in taxes. Cashed in some RRSP and re-mortgaged his home
- RM – Age 68 – Nortel
  - Using deferral, took shares to avoid options expiring. Owed \$40K+ in taxes before the shares were even delivered! Liability now \$220k, praying he dies before Nortel is sold! Too old for a mortgage, would have to sell his house or cash \$300k of RRSP's
- KH – Age 50. ACD Systems.
  - Forced sale due to the company going private triggers a deemed disposition of \$1.2M against a “real gain” of \$54K. Owes 5X more in tax than received from sale of stock. The Tax on the imaginary proceed will wipe out RRSP and force mortgage.
- CJ – Age 42. Entrust
  - Single mother of two, recently received a tax bill for \$50K, for deferred shares that were sold three years ago, at a significant loss for \$2000

# The JDSU episode

- Gary Lunn fought on behalf of some of his constituents in this situation and obtained remission for them.
- “It is not in the government’s interest to tax people on money never seen.” – Gary Lunn
- Remission order approved by Prime Minister Harper
- “...it is in the public interest to do so...” - the Right Honourable Michaëlle Jean Governor General of Canada

**What about the rest of us?**

## Fair treatment is largely revenue neutral over time

- Everyone who is assessed an employment gain on phantom income gets a corresponding capital loss in their CRA record
- While the person is alive, this capital loss is applied against new capital gains
- When the person dies, the capital loss is applied against the disposition of their estate (which often includes cashing-out of registered plans, sale of property and assets,...)
- For people who defer the stock option benefit until they die, the capital loss immediately offsets the employment benefit
- Over time, this is largely a zero-sum game for the government

**Aside from fairness, why force people to live in stress and misery when there is no financial gain to the government?**

# South of the border

- Stock Options are assessed at sale, not exercise and valued fairly
  - “If the sales price of the shares is less than the Fair Market Value on the date of exercise, the amount of ordinary income is limited to the amount of gain, if any.”
- People ran afoul of the AMT with profound impacts similar to Canada
  - AMT causes a “prepay” but gives the money back in credits but over a very long time
- Influenced by fairness, situations of financial ruin and even two suicides, congress, in 2006, made AMT credits refundable at 20%/year
- Full refund introduced in Congress (Van Hollen) and Senate (John Kerry/Joe Lieberman) to fix the issue. Expected to pass in early 2008
  - Further accelerates credits (2 years), strikes outstanding unpaid taxes, interest and penalty obligations, and allows full refund of capital losses, interest, and penalties for all affected individuals regardless of income level
- Rep Van Hollen: "no one should lose their homes, savings, and retirement to a wildly disproportionate tax on phantom income they never saw, because our tax laws failed to anticipate the circumstances in which a number of our citizens now find themselves."

**If the US can fix it, surely Canada should**

# Made in Canada solutions

1. Allow the real capital loss on the shares to offset the paper employment income
  2. Value the gain on the shares at the fair market value when they are sold, not when they are exercised. This solution is adopted by the US.
- We are not seeking forgiveness of taxes as happened with JDSU, we are seeking a fair treatment that prevents taxation on phantom income based on an oversight

Any solution needs to be retroactive

# Summary

- We are ordinary hard-working Canadians. We are not thieves, tax evaders or financial speculators
- We are seeking fair and sensible tax treatment so people are not devastated by tax on phantom income due to an oversight in tax law
- We are seeking equal and fair treatment so a group of Canadians is not treated preferentially as is the case for the JDSU employees
- There are a number of fair ways to resolve the issue
- We count on your support as a fair-minded individual