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Employee Stock Options

The latest on taxation

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There have been a couple of recent developments concerning the taxation of employee stock options of which advisors should be aware. However, before discussing these, a quick review of the taxation of stock options is warranted.

The tax rules
Options give employees the opportunity to purchase shares of their employer for a predetermined price, known as the exercise price. The difference between the fair market value of the shares at the time the options are exercised and the exercise price must be included in the employee's income. New rules introduced in 2000 allow this income inclusion to be deferred until the year the shares are sold (subject to an annual $100,000 vesting limit). The employee is then generally entitled to claim a deduction equal to 50 per cent of the income inclusion, which means that the stock option benefit is taxed at the same rate as a capital gain.

Assume that Jack received 1,000 stock options to purchase shares of his employer at $10 each. The price on the day he exercises his options is $25. His employment benefit is $15,000 or ($25 - $10) X 1,000 shares. He may claim an offsetting deduction of $7,500, so that his net employment benefit is reduced to $7,500, which, subject to the $100,000 limit, will not be taxed until the year of sale.

The adjusted cost base (ACB) of Jack's shares is $25,000, calculated as $10,000 (exercise price of $10 X 1,000 options exercised) plus $15,000 (the option benefit determined above). When Jack ultimately disposes of the shares, a capital gain (or loss) may result. For example, if he sells the shares when the price increases to $30, his capital gain would be $5,000 ($30,000 - $25,000).

Underwater stock options
What if Jack had sold the shares when the price was only $20? Jack would now realize a capital loss of $5,000. This capital loss can't be used to offset the option benefit of $15,000 as the option benefit is considered to be "employment income" and not a capital gain. Capital losses can only be applied against other capital gains in the current year or, alternatively, can be carried back three years or forward indefinitely to offset capital gains of other years.

It is this mismatch of employment income and capital loss that has caused much angst among employees who may have exercised options (perhaps because they were expiring) but continued to hold the shares. These employees may have lost significant amounts of money on the sale of option shares, yet also find themselves with a substantial tax bill on the option benefit, which was never monetized.

The Canada Customs and Revenue Agency (CCRA) is aware of this issue and has stated that it is currently under review by the Department of Finance. One solution that has been suggested to rectify the problem is that shareholders who have a capital loss on shares acquired by virtue of exercising options be allowed to apply the capital loss against the option gain (i.e., the employment benefit). The problem with this solution from a tax policy point of view is that once an employee has exercised stock options, he or she steps out

of the shoes of being merely an employee and becomes a shareholder. That individual has made a conscious decision to hold the shares instead of selling them immediately. Therefore, would it be appropriate to treat this person differently from someone else who purchases the same shares on the open market (as opposed to through an exercise of options) and may realize a capital loss on those shares at a later point in time? Surely, he or she should not be allowed to deduct this loss from his or her employment income. Because of this potential inequity, we are unlikely to see any changes to these rules in the near future.

Repricing of stock options

With the recent turbulence in the financial markets (particularly in the technology sector), repricing existing stock options has become a popular way to incent executives who have previously been granted options that are significantly underwater. There has always been a concern among tax practitioners that if the options were simply repriced (without actually being cancelled and new options issued in their place), such a repricing would disqualify the options from the 50 per cent option deduction upon ultimate sale. This is because in order for the options to qualify for this deduction, the fair market value of the shares on the day the options are granted cannot exceed the exercise price. On a repricing, this condition would, by construction, not be met.

Last year, the Department of Finance stated that they were prepared to allow a repricing of stock options (retroactive to 1999) without the need to reissue new stock options and still have them qualify for the option benefit deduction of 50 per cent. This is good news for your clients who may have received stock options in the past and who find that they are now being repriced given today's market environment.