THE NAVIGATOR

TAXATION OF EMPLOYEE STOCK OPTIONS

The taxation of employee stock options can be complex, as there are numerous factors that determine how much is taxable, when the tax liability is triggered and whether the tax liability can be deferred. The following article outlines the rules and presents several common scenarios you may encounter.

PUBLIC VERSUS PRIVATE COMPANIES

There are a number of factors that determine how and when an employee stock option will be taxed. A key consideration is whether the company issuing the shares is a public corporation or a Canadian Controlled Private Corporation (CCPC). A CCPC is generally a Canadian corporation, whose shares are not listed on a prescribed stock exchange and which is not "controlled" by either a public corporation or a non-resident. Points specific to CCPCs are highlighted below, under the section "Private Company (CCPC) Shares – Stock Option Benefit."

PUBLIC COMPANY SHARES — STOCK OPTION BENEFIT

Generally, there are no tax implications to you when the stock options are first granted. However, when you decide to exercise the options, the difference between the fair market value (FMV) of the shares at the time you exercise the options and the amount you pay for the shares (exercise or strike price) is considered to be a stock option benefit. This benefit is taxable to you as employment income in the year you exercise the options. You may qualify for a stock option deduction for qualifying shares equal to half of the stock option benefit that is included in your income (see below under "Stock Option Deduction for Qualifying Shares"). Both the stock option benefit and the stock option deduction are reported on your T4 slip, along with your salary, bonus and other sources of income.

The stock option benefit is taxable to you as employment income in the year that you exercise the options, regardless of which year the options were granted or which year you decide to actually sell the shares acquired using the options.

Although the stock option benefit is taxed as employment income, future appreciation of the stock after the exercise date (if you hold the shares and do not sell them immediately after exercising the options), is taxed as a normal capital gain or loss. Your adjusted cost basis (ACB) of the shares is the FMV of the shares at the time you exercised the options.

STOCK OPTION DEDUCTION FOR QUALIFYING SHARES

In many instances, you may be eligible for a deduction equal to 50% of your stock option benefit. This is often referred to as a "stock option deduction." The intent of this deduction is to tax the stock option benefit at the same rate as capital gains. (Note to Quebec residents: Quebec only offers a 25% stock option deduction.)

The shares must "qualify" in order to receive this preferential treatment. This rule applies to employee stock options granted by both CCPCs and public corporations.

RBC Wealth Management

In many instances, you may be eligible for a deduction equal to 50% of your stock option benefit.

An employee stock option will be considered to qualify for the 50% deduction if it meets the following criteria:

- The employer corporation, or a corporation not dealing at arm's length with the employer corporation, is the corporation agreeing to sell or issue the shares;
- The employee stock option is in respect of common shares;
- At the time the employee stock option is granted, the exercise price is not less than the FMV of the shares. In the case of CCPC options, if the exercise price is less than the FMV of the shares at the time of grant, you may still qualify for the 50% deduction if you hold the shares for more than two years; and
- Immediately after the exercise of the options, the employee must be dealing at arm's length with their employer.

Example #1

Charley was granted employee stock options to purchase 100 common shares of public XYZ Co. on December 15, 2010. The exercise price of the XYZ Co. options was $15 per share and the FMV of these shares when the options were granted was $14 per share.

Charley exercised his options on February 1, 2011, when the FMV of the XYZ Co. shares were trading at $20 per share. Therefore, Charley has a $500 [($20-$15) x 100] taxable benefit to include in his 2011 income tax return.

However, Charley may be entitled to a 50% stock option deduction, if the following apply:

a) The employer corporation, XYZ Co., is selling or issuing the shares pursuant to the stock option agreement;

b) The employee stock option is in respect of common shares;

c) The exercise price ($15) was greater than or equal to the market price ($14) of the shares at the time the employee stock option was granted; and

d) After exercising the stock options, Charley is dealing at arm's length with XYZ Co. because he is simply an employee and has no significant ownership in, or influence over, XYZ Co.

The fact that Charley has met the criteria entitles him to a 50% stock option deduction. Therefore, the net inclusion on Charley's 2011 tax return will be $250 ($500-250).

Example #2

Assume your employer granted you 1,000 options of the company stock at an exercise price of $5 per share, which was the FMV of the shares when the options were granted. Your options are now fully vested and the current share price is $12 per share. You decide to exercise all of your stock options and therefore pay your employer the exercise price of $5,000 [$5 x 1,000] and in exchange receive 1,000 shares.

Two weeks later, the share price increases to $13 and you decide to sell all the shares for proceeds of $13,000 [$13 x 1,000].

The following table summarizes the tax implications:

Employees of a CCPC will not have a tax liability at the time of exercise, unlike employees of public companies who will have a tax liability when they exercise their employee stock options.

Stock option benefit added to your T4 employment income [($12 FMV at time of exercise - $5 strike price) x 1,000 shares]	$7,000
50% stock option deduction [$7,000 x 50%]	($3,500)
Net increase in taxable employment income	$3,500
Taxable capital gain on the $1 per share gain [($13 FMV- $12 ACB) x 1,000 @ 50% capital gain inclusion rate]	$ 500
Additional taxable income	**$4,000**

In total, your taxable income would increase by $4,000, which is 50% of the $8,000 true profit you realized [($13 sale proceeds - $5 paid by you) x 1,000 shares].

Private Company Shares (CCPC) – Stock Option Benefit

When it comes to employee stock options, there are two significant differences between CCPC shares and public company shares.

First, the timing of the stock option benefit discussed previously (i.e., taxable upon exercise) that applies to public company shares does not apply to CCPC shares until the shares are actually disposed of or deemed to have been disposed of. Therefore, employees of a CCPC will not have a tax liability at the time of exercise, unlike employees of public companies who will have a tax liability when they exercise their employee stock options.

Second, unlike a public company employee, even when the exercise price of their stock option is less than the FMV of the shares on the date of grant, a CCPC employee may still be eligible for the 50% stock option deduction against their stock option benefit. However, in this circumstance, to qualify for the 50% stock option deduction, the CCPC employee must hold their shares for a period of at least two years after exercising their stock options (except in the case of death).

If a corporation is a CCPC at the time of its agreement to sell or issue shares to its employees under a stock option, these CCPC rules discussed above will apply, even if the corporation ceases to be a CCPC prior to the issuance of the shares pursuant to the agreement. In essence, if a CCPC grants stock options to an employee and then becomes a public corporation before the employee exercises their options, the CCPC rules would still apply when the employee eventually exercises their options. A deferral of the stock option benefit inclusion until the ultimate sale of the shares and a 50% stock option deduction will still be available.

Example #3

In March 2008, Verna was granted an employee stock option that gave her the right to acquire 100 shares of Diamonds Inc. Diamonds Inc. is a CCPC. The exercise price on this option was $5 per share and the market price was $6 per share at the time of grant.

Due to favourable drilling results, the shares increased to an FMV of $20 in June 2009. Verna decided to exercise her option and acquired 100 Diamonds Inc. shares. Since Diamonds Inc. is a CCPC, there are no immediate tax consequences to Verna on exercising her options.

In July 2011, the shares were valued at $50 and Verna decided to sell her shares. Verna then realized an employment benefit for the amount that the FMV exceeded the exercise price on the day the option was exercised ($20-$5 = $15). Further, because Verna held her shares for more than two years, (from June 2009 to July 2011), Verna qualified for the 50% income deduction. The ACB of each share is the FMV at the time the option was exercised ($20). This ensures that Verna is not subject to any double taxation.

In summary, in 2011, Verna will have an employment income inclusion of $1,500 ($15 x 100 shares) and a corresponding deduction equal to half the inclusion ($750). She must also recognize a capital gain in the amount of $3,000 ([$50-$20] x 100) of which 50% is taxable ($1,500).

Deferral of Public Stock Option Benefit – Pre-March 4, 2010

Prior to the March 4, 2010 federal budget, if you decided to exercise your public company options and hold the shares, and if certain criteria were met, it was possible for you to defer the taxation of the stock option benefit until the shares were actually sold or deemed to be disposed of. Note that the 50% stock option deduction was also deferred until the stock option benefit is taxable. The ability to defer the tax (under certain circumstances) became available to employees who exercised public company stock options after February 27, 2000, even on stock options that were granted before this date. The March 4, 2010 federal budget eliminated this deferral for options exercised after March 4, 2010.

The deferral was available to eligible employees if certain criteria were met. An eligible employee is one who, at the time the option was granted, dealt with the employer and related corporations at arm's length and is not a "specified shareholder." Generally, a specified shareholder is anyone who holds, directly or through related persons, 10% or more of any class of shares of the corporation, or one related to it.

The tax deferral was allowed if, at the time that the employee stock option was granted, the FMV of the security was equal to or less than the exercise price of the employee stock option, and if the employee was a resident of Canada at the time the option was exercised. The stock option had to be for shares listed on a prescribed Canadian or foreign stock exchange. Prescribed stock

The March 4, 2010 federal budget eliminated this deferral for options exercised after March 4, 2010.

There are situations where you might be deemed to have disposed of your shares under the income tax rules.

exchanges include most Canadian, American and world markets.

If the conditions were met, the stock option benefit could be deferred until such time that the eligible employee disposed of the security or the security is deemed to be disposed of by Canadian tax rules.

Previously, there was an annual limit to the number of shares that qualified for the deferral of the stock option benefit. This limit was based on a maximum specified value of $100,000 for each year that stock options vested or became exercisable; for options above that limit, the stock option benefit was taxable when the options were exercised.

The $100,000 maximum specified value was based on the following factors for each year that the stock options vested or became exercisable:

a) The number of shares under the option; and

b) The FMV of the underlying shares at the time the employee stock option was granted.

The product of (a) and (b) (referred to as "specified value") determined how many of the shares acquired were eligible for a deferral. If the product was less than or equal to $100,000, then a full deferral was available. If the specified value exceeded $100,000, then the excess was immediately taxable.

Although the specified value is normally the FMV of the underlying share at the time the option is granted, the specified value should be adjusted to take into account any exchanges of options or any underlying shares that have been split or consolidated.

The following example illustrates these rules.

Example #4

Jennifer worked for a public company that offered her employee stock options. These employee stock options allowed Jennifer to acquire 100,000 shares. At the time that these employee stock options were granted, the exercise price was $4 per share and the FMV of the shares was also $4.

Jennifer was permitted to exercise employee stock options for 20,000 shares on January 1, 2006, 60,000 shares on January 1, 2007 and the remaining 20,000 shares on January 1, 2008. On January 1, 2008, the FMV of these shares were $20 per share.

The specified value for each vesting year is calculated as follows:

January 1, 2006: (20,000 shares x $4 per share = $80,000)

January 1, 2007: (60,000 shares x $4 per share = $240,000)

January 1, 2008: (20,000 shares x $4 per share = $80,000)

Jennifer would have included in income a portion of the employee stock option benefit when she exercised the employee stock options that vested on January 1, 2007 because the $100,000 maximum specified value had been exceeded for 2007.

The maximum number of shares for which the deferral would have been permitted is 25,000 shares (25,000 shares @ $4 = $100,000). Therefore, 35,000 shares (60,000-25,000 shares) would have created an immediate taxable amount when the employee stock options were exercised.

The stock option benefit included in income when the employee stock options were exercised was calculated as follows, assuming that Jennifer exercised all of the options on January 1, 2008:

- $400,000 (100,000 shares x exercise price of $4) in funds required to exercise all the employee stock options
- $1,600,000 (100,000 shares x [$20 – 4]) stock option benefit
- The employment benefit on the 20,000 shares that vested in 2006 and 2008 was deferred, but the deferral of the stock option benefit related to the shares that vested in 2007 was limited to only 25,000 shares:
  - $1,040,000 (65,000 shares x [$20-4]) of the employment benefit can be deferred. This amount of the stock option benefit

This election for special relief is not available if your shares have declined in value, but the proceeds on their sale are still sufficient to pay the tax that was deferred when your options were exercised.

will become taxable once Jennifer disposes of her shares or they are deemed to be disposed of.

- $560,000 (35,000 shares x [$20 – 4]) of the employment benefit cannot be deferred and will be taxable immediately on exercise of the options.
- In the year of exercise, Jennifer would also have been able to get a stock option deduction equal to 50% of the $560,000 stock option benefit, assuming the shares qualify.

Deemed Disposition of Shares

Once you dispose of your shares, the deferred stock option benefit must be included in your income in the year of disposition. Besides the actual disposition of your shares, there are situations where you might be deemed to have disposed of your shares under the income tax rules. Some of the other situations may include (but are not limited to):

- On death
- On becoming a non-resident (with exceptions)
- On transfer of the shares to a registered plan
- On transfer of the shares to another individual (including a spouse)
- On transfer of the shares to a corporation — even if done on a rollover basis using subsection 85(1) of the Income Tax Act
- On transfer of the shares to a trust

Special Relief for Deferred Stock Option Benefits

Imagine a scenario where you exercised your options for public company shares and held the shares. You also elected to defer the stock option benefit until you disposed of the shares. In the meantime, the value of your shares declined significantly. So much so that the value of your shares are less than the amount of the tax deferred in the year of exercise.

Fortunately, the March 4, 2010 federal budget introduced rules that provide relief for individuals in this exact position, if they dispose of their shares before 2015. The rules allow you to elect to limit the tax liability relating to the stock option benefit if the shares are disposed of before 2015. If you make this election, your tax liability will be equal to the proceeds received from the sale of the shares (or two-thirds of the proceeds in the case of Quebec residents).

Specifically, when you make this election:

1. You will pay a special tax equal to the proceeds from the disposition of the shares (or two-thirds of the proceeds in the case of Quebec residents);
2. You will be entitled to a deduction equal to the amount of the stock option benefit in computing your taxable income; and
3. You will include in your income as a taxable capital gain an amount equal to one-half of the lesser of:
   a) the stock option benefit; and
   b) the capital loss realized on disposition of the shares.

The effect of these rules is to re-characterize all, or a portion of, the reduction to the stock option benefit as a taxable capital gain, so that you will not have the benefit of the capital loss that would otherwise arise where you have elected to pay a reduced tax liability.

This election for special relief is not available if your shares have declined in value, but the proceeds on their sale are still sufficient to pay the tax that was deferred when your options were exercised. In addition, this

Tax Result 2011		
Include in income the stock option benefit deferred		$ 7,500
Less: special stock option deduction		(7,500)
Income inclusion		0
Special tax – equal to proceeds on sale of shares	**2,500**	
Proceeds of disposition		2,500
ACB of shares		(15,000)
Capital loss on sale of shares		(12,500)
Allowable capital loss (50% x $12,500)		(6,250)
Special adjustment as a taxable capital gain *		3,750
Revised net capital loss		(2,500)
* Special adjustment as a taxable capital gain		
50% of the lesser of:		
(a) stock option benefit	$7,500	
(b) capital loss realized on sale of shares	12,500	
Therefore, special adjustment is 50% of $7,500 =	3,750	

election is not available to individuals where the options granted were for shares of a CCPC.

Example #5

Oscar worked for a public corporation that had a stock option plan in which he was granted 500 options with a strike price of $15. Oscar exercised all 500 options when the FMV was $30. He decided not to sell the shares and filed an election to defer paying taxes on the stock option benefit. The stock option benefit deferred was $7,500, the difference between what he paid ($7,500) and what the stock was worth ($15,000).

Oscar decided to sell the shares in 2011, when the FMV was $5 a share and his tax rate was 46%. His proceeds on the sale of the 500 shares was $2,500 (500 x $5). He, therefore, had a capital loss of $12,500 ($2,500 - $15,000).

If he makes the special relief election with his 2011 tax return, he will have to pay tax equal to the proceeds of disposition of $2,500. He will be allowed a deduction equal to the amount of his stock option benefit of $7,500, and will have to include in his income as a taxable capital gain an amount equal to one-half of the lesser of:

a. the stock option benefit ($7,500); and

b. the capital loss realized on disposition of the shares ($12,500).

Therefore, $3,750 will be included as a taxable capital gain (50% of $7,500). This amount can be offset by the allowable capital loss incurred on the disposition of the shares that were originally acquired by the stock option or by any other allowable capital losses.

To make the special election, you must elect on or before your tax return filing deadline for the year in which you dispose of your shares. If you were in this position and you disposed of your shares before 2010, you may still elect retroactively, if you do so on or before your 2010 filing deadline.

Cash-Out of Stock Options

A cash-out of stock options is where a company pays you cash instead of shares at the time of exercising your stock options. This allows the corporation to claim a deduction for the cash paid, whereas issuing shares does not. In addition, prior to the March 4, 2010 federal budget, in a cash-out of employee stock options, you were permitted to claim the 50% stock option deduction where certain conditions were met (as discussed previously).

A cash-out of stock options should not be confused with a cashless exercise of your stock options (discussed later in this article). The rules discussed in this section do not apply to a cashless exercise of your options.

The 2010 federal budget introduced rules that prevent both the employer and employee from claiming a deduction in a cash-out of stock options. In a cash-out transaction of stock options, you may only claim the 50% stock option deduction if your employer files an election with the Canada Revenue Agency (CRA) stating that they will not deduct any amount paid to you in respect of your disposition of rights under the stock option agreement. Your employer must provide you with a statement that they made this election. You must then file the statement from your employer with your tax return for the year in which you receive the stock option benefit.

Withholding Tax on Stock Option Benefit

The 2010 federal budget introduced rules that make it mandatory for employers to withhold taxes on a stock option benefit, net of the stock option deduction, at the time of exercise of the option where the options are exercised after 2010. In addition, your employer will not be permitted to reduce withholding taxes on your stock option benefit by claiming the withholding tax will cause you hardship.

> They may use a cashless exercise method that involves short selling the underlying stock as a means of acquiring the cash needed to exercise their options.

This means that, if you are exercising options, you may have to sell sufficient shares at the time of exercise of your options or, if your plan permits, your employer may be allowed to reduce the number of shares issued to you to cover the tax on the stock option benefit that arises upon exercise.

RRSPs and Employee Stock Options

You can contribute stock options, in-kind, to an RRSP, as long as the underlying security is an eligible investment for RRSP purposes. The amount of the contribution is the FMV of the option at the time of contribution. Although the method to be used in determining the FMV of the option is not specified in the legislation, CRA has stated that the FMV of an option contributed to an RRSP is the "intrinsic value" at the time of contribution. The intrinsic value is the amount, if any, by which the current market value of the underlying shares exceeds the exercise price of the option.

Example #6

The current market price of ZZZ Inc., a public corporation, is $10 per share and the exercise price of the employee stock option is $7 per share. Therefore, the in-kind contribution to the RRSP is $3 per share ($10-$7).

There is no stock option benefit at the time the option is contributed to the RRSP. However, once the options are exercised, you will have a stock option benefit even if the options are exercised within the RRSP. In these circumstances, it would still be possible for you to claim the 50% stock option deduction, if certain conditions, previously discussed, were met.

A problem may arise when employee stock options are exercised within an RRSP, since employers are now required to withhold tax on the exercise of stock options. If this is done by selling some of the shares to cover the withholding tax or by issuing fewer shares, this would result in an income inclusion (RRSP income) for the employee. Basically, it is as if the employee withdrew the amount from the RRSP to pay the tax liability arising on the exercise of the stock options held in the RRSP. One way to deal with this problem may be for the employer to withhold taxes related to the exercise of the stock options from the employee's other salary and bonus. Therefore, it is important to discuss this with your employer, if you are considering contributing your stock options to your RRSP.

Another consideration when contributing an employee stock option to an RRSP is the potential for double tax. As explained above, you would have an income inclusion when the option is exercised inside the RRSP, although you may be entitled to the 50% stock option deduction. However, when the funds are ultimately withdrawn from the RRSP, the full amount of the withdrawal is taxable.

Cashless Exercise of Stock Options

Some employees have stock options but do not have the cash needed to pay for the shares upon exercise of the options. Because of this, they may use a cashless exercise method that involves short selling the underlying stock as a means of acquiring the cash needed to exercise their options.

Generally, short selling is a speculative practice that involves selling securities that you do not own with the hope that the price of the stock will fall, allowing you to acquire the shares at a lower

There are income tax rules that determine the order of disposition of securities acquired under a stock option agreement.

price to cover the short sale. For tax purposes, the CRA generally considers income and losses from short selling to be ordinary income and not capital gains or losses (i.e., 100% taxable). However, there are circumstances in which the gain or loss on the short sale can be considered a capital gain or loss. You should consult with your professional tax advisor to determine how any gain or loss, if any, on a cashless exercise of your stock option should be classified.

The risk of a cashless exercise of your stock options is that the price of the stock may change from the time of the short sale to the time you receive the stock from your employer. The FMV of the stock on the date you acquire the stock is the value used to calculate your stock option benefit and your ACB of your shares. If the FMV on the date you acquired your shares is different from the price received on the short sale, then you will have a gain or loss.

Identical Property

Once an employee stock option is exercised, the ACB of the newly-acquired shares is the FMV of the shares at the time of exercise. However, under normal circumstances, this cost determination would be incorrect if you already owned other identical shares. The ACB of all of your identical shares would be a weighted average cost of all the securities owned.

Fortunately, the CRA has dealt with this problem by exempting certain securities acquired after February 27, 2000 from the weighted average cost rule by deeming such securities not to be identical to any other securities where the weighted average cost rule would normally apply.

The specific securities that are granted this exemption are any of the following:

a) Employee stock options from a CCPC;

b) Employee stock options from a public corporation where (prior to March 4, 2010) an election for a deferral of the stock option benefit was made; or

c) Employee stock options that are exercised and are disposed of within 30 days of acquiring the shares, where you identify the particular security as such in your tax return for the year in which the disposition occurs. In addition, you are prohibited from acquiring or disposing of any other identical securities in the period between the exercise of the options and the disposition of the securities obtained under the option.

The effect of this exemption is that the capital gain or loss on the disposition of your securities is determined without regard to the ACB of any other identical securities you own; i.e., each security to which these rules apply has its own ACB that is equal to the FMV of the securities at the time the options were exercised.

Example #7

On April 1, 2009, Rob was offered employee stock options of XYZ bank, a public corporation. The exercise price was $20 a share and the FMV of the stock was also $20. On November 15, 2009, Rob was offered additional employee stock options with an exercise price of $25 for shares with the same FMV. On December 15, 2009, Rob exercised all of his options when the shares had a FMV of $50, and he elected to defer the stock option benefit.

Since Rob elected to defer the stock option benefit, the rules discussed in this section would apply. Therefore Rob has generated two separate pools of assets, each with their own ACB. The first pool consists of the securities with a stock option benefit of $30 per share ($50-$20) and an ACB of $50. The second pool of securities has a stock option benefit of $25 ($50-$25) and an ACB of $50.

There are income tax rules that determine the order of disposition of securities acquired under a stock option agreement. The rules make a distinction between securities acquired under a stock option agreement where a stock option benefit deferral applies and where no deferral applies. We shall refer to these as "deferral securities" and "non-deferral securities" respectively. First, a taxpayer is deemed to have disposed of securities that are identical properties in the order in which the taxpayer acquired them. For this purpose, a taxpayer is deemed to have acquired non-deferral securities prior to deferral securities. Where a taxpayer acquires identical deferral securities at the same time, the taxpayer is deemed to have acquired

If you become a non-resident of Canada, you are not considered to have disposed of your employee stock options. However, if you exercise these employee stock options as a non-resident, the stock option benefit will be taxable in Canada as employment income because the employment for which the stock options were granted was performed in Canada.

them in the order in which the relevant options were granted.

Example #8

Frank purchased 10 shares of GRT Inc. (a public corporation) on the secondary market for $10 a share on January 1, 2009. Frank purchased 10 more shares of GRT Inc. on the secondary market for $20 a share on February 1, 2009.

The unit cost of these 20 identical shares was $15 per share ([(10 x $10) + (10 x $20)]/20 shares). This pool of assets was part of his non-deferral securities.

On June 1, 2009, Frank exercised an employee stock option and acquired 1 additional share. The FMV of the share was $40 and the exercise price was $10 (granted on May 1, 2005). Frank filed an election to defer the stock option benefit of $30 ($40-$10). Because of the deferral election, this share of GRT Inc. is excluded from the weighted average cost rule. Hence, the ACB of this share was $40.

Frank now had two pools of assets: non-deferral shares with an ACB of $15 (20 shares) and a deferral share with an ACB of $40 and a deferred stock option benefit of $30.

On September 3, 2009, Frank acquired an additional stock option share. The share was selling at $60 a share and the exercise price was $10 (granted on December 1, 2005). Once again, Frank elected to defer the stock option benefit of $50 ($60-$10). Because of this election, the share was again excluded from the weighted average cost rule. The ACB of this share was $60 and there was a deferred stock option benefit of $50.

There were now three pools of assets:

1) Non-deferral shares with an ACB of $15 (20 shares);
2) A deferral share with an ACB of $40 and a deferred stock option benefit of $30; and
3) A deferral share with an ACB of $60 and a deferred stock option benefit of $50.

On January 1, 2010, Frank sold 15 shares of GRT Inc. for $115 a share. Due to the ordering rules, Frank was deemed to have sold from the non-deferral pool before selling from the deferral pool. Therefore, Frank generated a capital gain of $1,500 ([$115-15] x 15 shares).

On April 6, 2010, Frank sold 6 shares of GRT Inc. for $165 a share. Once again, the ordering rules required that he utilize the non-deferral shares before the deferral shares, and then the deferral shares based on the earliest acquired.

Therefore, Frank had a capital gain of $875 and an employment income inclusion of $30.

The capital gain was calculated as follows: 5 non-deferral shares x ($165-$15) = $750, 1 deferral share x ($165-$40) = $125, for a total capital gain of $875 ($750 + $125).

In addition, since a deferral share was sold, we must also include the deferred stock option benefit as an income inclusion ($30). However, if this share qualified for the stock option deduction, then Frank would also be able to claim a stock option deduction of $15.

If you have any identical property that was purchased prior to 1972, If you have a significant employee stock option benefit, you may be subject to AMT.

the calculations are more complex and you should seek advice from a qualified tax professional.

Non-Residents

If you become a non-resident of Canada, you are not considered to have disposed of your employee stock options. However, if you exercise these employee stock options as a non-resident, the stock option benefit will be taxable in Canada as employment income because the employment for which the stock options were granted was performed in Canada. If the stock options were granted for CCPC shares, then the stock option benefit can be deferred until you dispose of the shares.

However, if you have already exercised an employee stock option for CCPC shares and you are holding these shares when you become a non-resident of Canada, generally you will be deemed to have disposed of your shares at that time. The deemed disposition rules will create a capital gain or a capital loss on disposition; however, the stock option benefit can still be deferred until you actually dispose of your CCPC shares.

Unfortunately, this deferral does not apply to public company shares. Hence, if you cease Canadian residency while holding public company shares, you will be deemed to have disposed of these shares resulting in a capital gain or loss. In addition, if you were able to defer the stock option benefit at the time of exercise under the rules that existed before March 4, 2010, then you will also have to include the stock option benefit at the time of ceasing residency.

The departure tax rules are complex; therefore, you should consult with a qualified tax professional if you are considering ceasing Canadian residency.

Alternative Minimum Tax (AMT)

If you have a significant employee stock option benefit, you may be subject to AMT. The AMT is the government's attempt to ensure that high-income earners, who make specific deductions to reduce their taxes payable, pay a minimum amount of taxes annually.

In particular, the 50% stock option deduction is one of the deductions that affect AMT. Therefore, you should always consider AMT when you are claiming the 50% stock option deduction. It may reduce your regular income tax, but may also affect your overall tax bill because you have to pay AMT.

Charitable Donations of Shares Acquired with Employee Stock Options

You may receive an additional 50% deduction against your stock option benefit, in addition to the normal 50% (normal 25% for Quebec residents) stock option deduction (for a total deduction of 100% and 75% for Quebec residents), if you donate the public company shares received to a qualified charity in the same year of exercise and within 30 days of exercising the options. The effect of this strategy is to eliminate the tax on the stock option benefit for everyone other than Quebec residents.

In addition to eliminating or reducing the tax on your stock option benefit, you will also receive a donation tax receipt equal to the FMV of the shares donated. This donation receipt can be used to reduce the tax payable on other taxable income, usually dollar for dollar. For example, a donation receipt equal to $10,000 means that you do not have to pay tax on approximately $10,000 of your compensation.

The key to this strategy is to donate the shares in the same year of exercise and within 30 days of exercise. If you expect to make donations during the year (especially near year-end) and you have options that are expiring this year, consider donating a portion of the stock acquired upon exercise to fulfill your annual charitable giving goals in order to reduce your out-of-pocket donation cost.

For a more detailed explanation of the advantages of gifting public company shares directly to a registered charity, please ask your Advisor for a copy of the article called "Charitable Donation of Employee Stock Options."

Taxation of Employee Stock Options on Death

Tax implications on death can be very complex and, in such situations, your legal representative should consult with a qualified professional tax advisor. In this section, we touch only on some of

For more information about the topics discussed in this article, please contact us.

the tax implications on death specific to employee stock options.

If you die holding shares acquired under an employee stock option where the stock option benefit has been deferred, you will be deemed to have disposed of your shares; therefore, your legal representative will have to include the stock option benefit on your terminal tax return. If certain conditions are met (as previously discussed), then your legal representative will also be able to claim the 50% stock option deduction on your terminal return. For CCPC shares, if you die before the two-year holding period, the 50% stock option deduction may still be claimed on your terminal return.

If you have unexercised stock options at the time of death, then you are deemed to have received as employment income a benefit equal to the FMV of the options immediately after death, less any amount, if any, that you paid to acquire the options. This amount should be reported on your terminal return. The 50% stock option deduction can still be claimed on your terminal return if certain conditions are met (as previously discussed). However, in this case, the amount is calculated as 50% of the difference between the FMV of your options immediately after death, less any amount you paid to acquire the options.

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

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