I Comparison of the Taxation of Equity Based Compensation (Stock Options) in the United States and Canada*

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1.01 Introduction

Equity based compensation is used by companies in both the United States and Canada. Stock option plans and employee stock purchase plans provide additional flexibility to attract employees and to encourage loyalty to the company.

The tax treatment of equity based compensation can vary widely depending on the treatment in Canada, the U.S. or whether the employee is subject to the tax rules of both countries (such as a U.S. citizen in Canada, or a resident of Canada working in the U.S.)

1.02 U.S. Income Taxation of Qualified Stock Options

(a) What is a Qualified Stock Option?

In order to be considered a qualified stock option, also called Incentive Stock Options (ISO's) several conditions must be met. First of all, the options must be granted only to employees of the company.

Further, the employee must be granted the option at fair market value (FMV) as of the date of the grant. If the employee is a greater than 10% shareholder of the company, certain additional conditions apply to maintain ISO status:

- the grant date must be 110% of FMV as of the grant date, and
- The option term cannot exceed 5 years from the grant date.

The exercise price cannot be less than the FMV of the stock at the grant date.

The total value of the stock option granted to each employee each year cannot exceed $100,000 as of the grant date, and the option must be exercised within 10 years of the grant.

After exercise, the employee must wait at least a year before selling the acquired stock (which is two years from the date the option was granted). ISO's must not be transferable to any other party, and must be granted to, exercised by and sold by the employee.

The option plan must be approved by the employer's shareholders within 12 months before or after the date the plan is adopted.

If any of the above conditions are not met, the option becomes a non qualified stock option, which brings with it different tax consequences.

(b) Advantage of a Qualified Stock Option

There is no income tax effect when an employee is granted a QSO and when the option is exercised after one year.

Upon sale of the shares, the employee receives long term capital gains treatment which results in tax rates which range from zero in the low tax brackets, 15% for income up to $450,000 (married filing jointly) or $400,000 (single), and 20% for income over the top rate.

The employer does not receive an income tax deduction for ISO's.

(c) Effect of Alternative Minimum Tax on ISO Exercises

Alternative Minimum Tax (AMT) may arise upon the exercise of an ISO notwithstanding that the exercise is otherwise not a taxable event.

The "spread" between the fair market value (FMV) at exercise and the grant price, although not immediately taxable, is considered a preference item for AMT purposes. This may give rise to AMT under certain conditions, so care must be taken to ensure that the quantity of ISO's exercised to do not give rise to AMT. Certain other strategies to avoid AMT involve exercising early in the year and monitoring the stock price. If the stock price declines the shares may be sold, and although that may be a disqualifying disposition AMT on phantom income would be eliminated. If the stock price increases then the employee may not be concerned about AMT since it would be recovered eventually when the shares are sold.

(d) Non Qualified Stock Options

A non qualified stock option (NQSO) may be issued to anyone, including employees, suppliers, directors and contractors, and in any amount. NQSO's may be granted at any price, and there is no require waiting period between grant and exercise.

Although there is no tax consequence at the grant date of a NQSO, exercising the option gives rise to ordinary income equal to the difference between the fair market value (FMV) at grant date and the FMV at exercise date.

One clear advantage to an issuing company is that the company receives a tax deduction (as compensation expense) equal to the amount reported by the recipient at exercise. Normal withholding taxes apply when a NQSO is exercised.

(e) Disqualifying Dispositions

If an ISO is disposed of prior to the required waiting period of one year after exercise, or within two years of the grant date, that act is called a "disqualifying disposition". If a disqualifying disposition occurs, an ISO takes on the characteristics of a NQSO.

When a disqualifying disposition occurs, the employee is subject to tax at regular rates based on the difference between the selling price of the shares and the grant price.

Event	Non Qualified Options	Qualified Stock Options
1. Waiting	No restrictions	Wait one year after grant
	on exercise	before exercise
2. Exercise price	No restrictions	At least FMV at time of grant
		except for over 10% owners
		where exercise must be 110%
		of FMV at grant date.
3. Recipient	Can be employee or non	Must be employee
	employee	
4. Grant date	No taxable benefit	No taxable benefit
5. Exercise date	Ordinary income equal to	No taxable benefit
	FMV at exercise less FMV	
	at grant date.	
6. Sale Date	Capital gain equal to sale	Capital gains treatment if
	price less FMV at	held for one year after
	exercese date	exercise.
7. Tax Effect for Employer	Company may deduct	No deductions.
	ordinary income declared	
	by recipient (withholding	
	applies.	
8. Value of Stock	No limit on value of	Value at grant date may not
	stock which may be	exceed $100,000 for first
	received.	time exercise.
9. Holding Period	No restrictions	Employee must hold shares for
		at least one year after exercise
		or two years from grant.
		Must be exercised within 10
		years of grant date.
10. Transferability	May be transferred.	No transfer available .

(f) Cashless Exercise

When a NQSO is exercised there is a immediate income inclusion equal to the FMV at exercise less the FMV at grant date. However, since there are no time restrictions on when the newly acquired shares may be sold, a sufficient number of the newly acquire shares may be sold immediately to fund the required income tax withholding and/or the grant price of the shares.

This is known as a cashless exercise, because the net result is that shares are exercised without the employee having to pay cash for the grant price or the income tax withholding resultant from the exercise.

Although the gain realized as a result of exercise of the NQSO's is given regular income treatment, the FMV at exercise also becomes the basis of the remaining shares held by the employee. If these shares are then held for over a year, the net gain over this basis is treated as a long term capital gain, taxable at the reduced rates referred to above. If the shares are sold before being held for a year, any further gain would be treated as a short term capital gain, which is treated as ordinary income.

As an alternative, sometimes the company will lend money to the employee to fund the purchase of stock.

1.03 U.S Restricted Stock and Restricted Stock Units (RSU's)

(a) Restricted Stock Tax Treatment

Often a company will issue shares to an employee to hold pending some event, such as the completion of a number of years of employment, etc. The shares are actually issued to the employee but must be returned unless they subsequently vest when the underlying conditions are met. At this stage the shares are deemed to have a "substantial risk of forfeiture".

There is no tax effect to the employee when the shares are originally issued.

When the shares finally vest, there is no longer a "substantial risk of forfeiture", and the employee must include the difference between the FMV of the shares vested and the amount they are required to pay for them, in ordinary income.

When the stock is finally sold, a capital gain/loss is recognized based on the holding period since vesting. The basis of the shares equals the amount paid for them plus any amount included in income on vesting.

(b) Making an 83(b) Election

When an 83(b) election is made, ordinary income is reported at the time the stock is granted, rather than when it vests. The ordinary income is the fair market value of the stock on grant date. When the stock vests, there is no further income reported, but a capital gain equal to the selling price of the shares less the amount reported in income on grant is reported. If the holding period since grant date exceeds one year, a long term capital gain is reported.

The advantage of an 83(b) election is most evident when the stock has little value on grant date and continues to increase in value. Although the same amount of gain is reported in the long run, when an 83(b) election is made it is possible that little or no income may be reportable at grant, and a majority of the gain is taxed at more favorable capital gains rates.

An 83(b) election, once made, may not be revoked without IRS approval. Generally revocation requests made within 30 days of grant are approved, but later requests must prove that a "mistake of fact" or "unconscious ignorance of a fact material to the transaction" must be proven.

(c) Forfeiture of Restricted Stock

When Restricted Stock is forfeited by an employee after making an 83(b) election or when an amount is paid for the shares, a capital loss may be recognized.

(d) Restricted Stock Units (RSU's)

No 83(b) election is permitted in respect of Restricted Stock Units (RSU's) since the stock has not actually been issued at the time of grant. In the case of RSU's regular income equal to the FMV of the underlying stock (less any amount paid) is included at the time of vesting.

(e) Dividends on Restricted Stock

Dividends received on Restricted Stock are treated as ordinary income unless an 83(2) election is made. When an 83(2) election is made, dividend tax treatment is available.

1.04 Canadian Treatment of Stock Based Compensation

In Canada, share based compensation takes one of three basic forms:

- Employee Stock Purchase Plan (ESPP) under which an employee may purchase shares at a discount, and will pay tax on the value of the shares acquired less the amount paid;
- Stock bonus plan under which shares are given to an employee without cost;
- Stock Option plan, which allows the employee to acquire shares of the employer at a pre determined price.

(a) Canadian Controlled Private Corporations (CCPC)

Stock options received from a Canadian Controlled private company require no tax effect to be recorded when the option is granted, and no taxable benefit is included in income when the options are exercised.

However, upon sale of the shares, capital gains treatment is applied.

(b) Canadian Controlled Private Corporations (CCPC) – Application of the Lifetime Capital Gains Exemption on sale of Shares

If otherwise qualified, a Canadian resident who realizes a gain on the sale of stock option shares from a CCPC may be eligible to claim the lifetime capital gains exemption.

For 2018 the lifetime capital gains exemption is $848,252 (less any qualifying exemption claimed in any prior year.)

As a consequence, stock based compensation by a CCPC to a resident of Canada may result in to tax effect to the employee.

(c) Stock Options from a Public Company

The benefit from stock options received from public company is similarly not included in income when the options are granted, but at exercise the difference between the fair market value at exercise date less the strike price are included in income as a taxable benefit to the employee.

(d) Stock Option Deduction

If certain conditions are met, the employee including a taxable benefit from stock options may deduct 50% of the benefit. This deduction under Para 110(1)(d) of the Income Tax Act (Canada) is available if the following conditions are met:

- The employer offers the employee stock options;
- The shares are prescribed shares – equivalent to common shares;
- The employee does not pay more for the stock option than the benefit obtained; and
- The corporation deals with the employee at arms length.

Given that the stock options are included in income pursuant to Subsection 7(1) and a 50% deduction is taken under paragraph 110(1)(d), the net income included on the return is not a capital gain and may not be offset with capital losses.

1.05 Cross Border Effect of Stock Option Compensation

In general the cross border effect of stock option compensation may result in significantly more tax since the tax rules of both Canada and the U.S. must be taken into account.

(a) U.S. Citizen in Receipt of a Canadian Stock Option

Regardless of whether the Lifetime Capital Gains Exemption of the operation of Paragraph 110(1) (d) applies, when a U.S. citizen receives a Canadian stock option it will effectively be treated as a non qualifying stock option, and will be subject to ordinary income tax when the options are exercised.

If the shares are then held, and meet the holding period for a long term capital gain, long term capital gains rates would apply when the shares are sold. At that time the capital gain would be calculated by deducting the exercise price from selling price.

(b) Canadian Resident in Receipt of a U.S. Stock Option

If a person continues to be treated as a resident of Canada and is employed by a U.S. company in the United States, they may become entitled to stock option compensation.

Based on the analysis above, there may be some beneficial tax treatment for U.S. tax purposes, but the entire stock option benefit would be treated as compensation income fro Canadian purposes.

Since the rate of tax payable in the U.S. for stock option compensation would likely be lower than the tax on compensation income in Canada, additional tax would be payable to Canada in such a case.

Accordingly, Canadians who contemplate a long term employment situation in the U.S. should consider expatriating from Canada for tax purposes to prevent inclusion of the U.S. income in Canada at Canadian tax rates.

This summary has been designed to provide a concise overview of the subjects addressed, and may not be complete. Reference should be made to original legislation prior to acting on any matter, and professional advice should also be obtained.

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