VIEWPOINTS

Canada's Taxation of Stock Option Benefits: Could the SDL Remission Order Benefit Others?

by Steve Suarez

Steve Suarez is a partner with Osler, Hoskin & Harcourt LLP in Toronto.

Employees are often granted options (stock options) to acquire shares of their company as a form of employment compensation and as a productivity incentive. The use of employee stock options is particularly prevalent in sectors (such as technology) in which the value of the company's shares may experience a significant increase. Many people know someone who has experienced a major windfall as a result of having received employee stock options in a company whose shares appreciated.

In a recent situation, the Canadian government granted special tax relief to a small group of employees of one particular company who found themselves with unexpected tax bills as a result of holding shares acquired on the exercise of stock options in a company that experienced a rapid share price increase followed by a precipitous decline. As many other employee stock option holders have experienced similar circumstances, it is curious that the government chose to limit relief to a small number of employees of one particular employer.

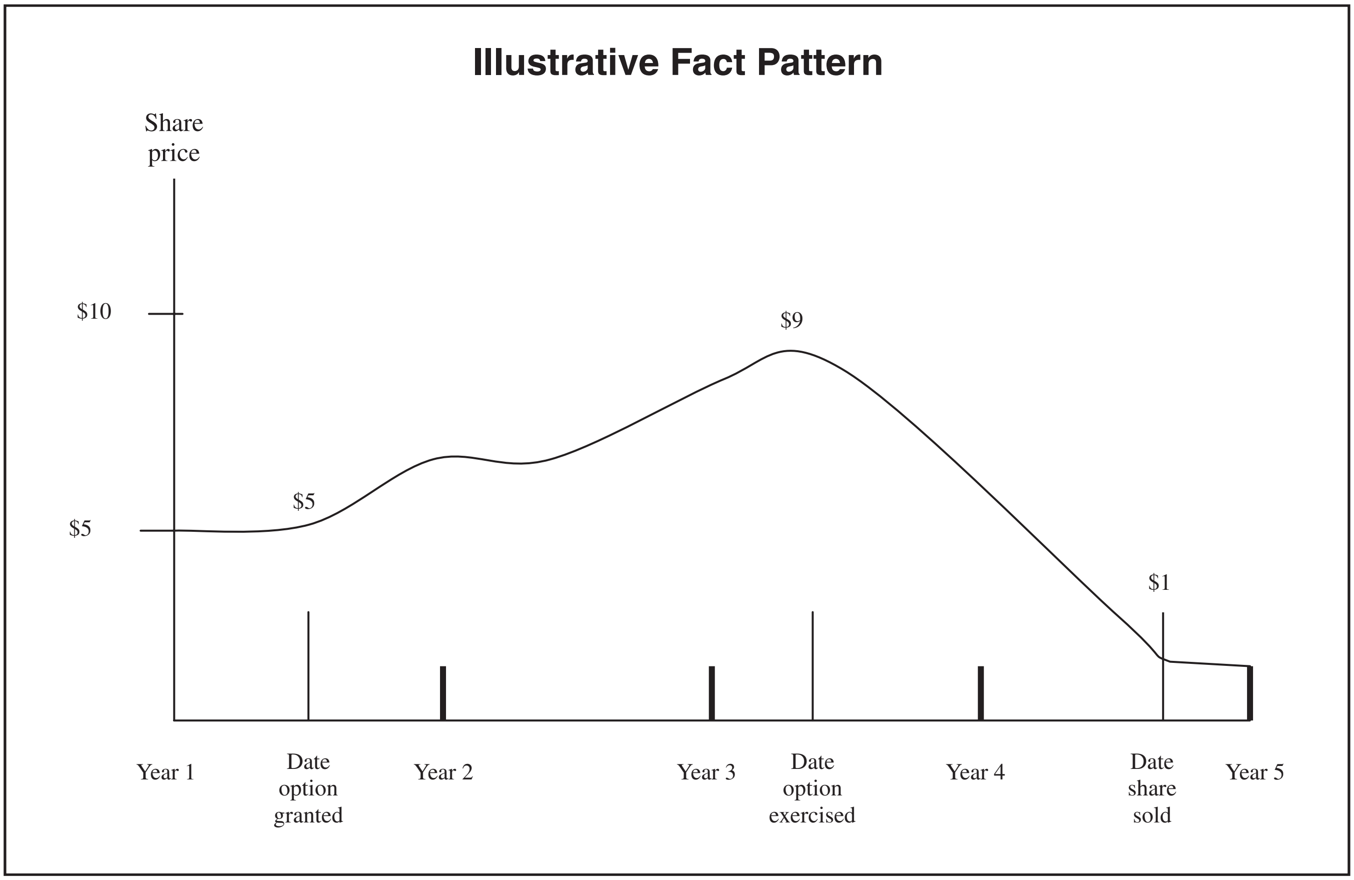
Employee Stock Options

To understand the situation in which the relevant individuals found themselves, a brief explanation is needed of how employee stock options are taxed in Canada. When an employer grants an employee the right to buy shares of the company, most typically the price the employee is entitled to buy the shares at (the exercise price) is equal to the fair market value of the employer's shares at the date the option is granted. If the value of those shares subsequently rises, the employee will typically exercise the option, pay the exercise price, and enjoy a gain equal to the difference between the value of the shares on the date of exercise and the exercise price paid. For tax purposes, all or part of that gain (typically 50 percent, under a deduction for qualifying stock options) is reported as a taxable benefit and included in the employee's taxable income.

What the employee does with the shares received on the exercise of the option is vital. If she sells the shares into the market immediately after exercising the option, she receives cash and is no longer subject to fluctuations in the share price; in effect the gain from the stock option is locked in and the tax on the stock option benefit can be paid from the share sale proceeds. If instead she keeps the shares, she remains exposed to any subsequent increase or decrease in the value of the shares, which for tax purposes will be a capital gain or loss. Because capital losses can only be used against capital gains (not the taxable benefit from exercising employee stock options), an employee who exercises a stock option (thereby crystallizing a taxable benefit and the tax payable), holds onto the shares, and later sells them at a reduced price ends up with a taxable benefit and a capital loss that cannot be used to offset it.

The figure on the following page illustrates this phenomenon for an employee who during year 1 is granted options to acquire her employer's shares when they are worth $5 per share. The share price increases, and in year 3 she exercises the option while the share price is at $9, thereby making a notional gain of $4 (and creating a taxable benefit of $2, assuming she qualifies for the reduced income inclusion rate on her stock option benefit). She continues to hold the share until midway through year 4, when she sells it for $1, thereby realizing a capital loss of $8.

The essential problem is that the $2 taxable benefit is considered employment income, and the capital loss cannot be offset against it; it can only be offset against capital gains. As such, the employee is left with tax owing on the employment benefit, a capital loss that may be of little or no use, and not much cash to pay the tax. Depending on how dramatic the share price



swings are between the time the option is granted and later exercised and the time the shares are sold, it could even be that the amount of cash left after selling the shares is insufficient to pay the tax owing on the taxable benefit, such that the employee would actually have been better off never to have received the stock options. Continuing to hold the shares after the exercise of the stock options is thus a risky proposition.

SDL Remission Order

This is the situation that some employees of SDL Optics Inc. found themselves in after SDL was acquired by JDS Uniphase. The value of the shares underlying their employee stock options ended up being much higher than the exercise price. Those who exercised their options and promptly sold their shares thereby generated cash, some of which could be used to pay the tax on their taxable benefits. Others who continued to hold their shares after exercising their options found themselves with large taxable benefits (since the value of the shares when acquired was dramatically higher than the exercise price) and little cash to pay the tax on them (since the shares sank in value by the time they were sold).

This phenomenon is by no means unique to SDL option holders. Many companies whose employees hold stock options have experienced similar circumstances. While the share price swings were particularly dramatic in this case, the principle is the same and other employee stock option holders have faced financial hardship in paying the tax owing on their taxable benefits. Nonetheless, the former SDL employees pushed elected officials for relief from the taxes (and interest on those taxes) clearly owing under the law. Their efforts were rewarded in late 2007, when the government issued a remission order waiving the taxes and interest owing.[1]

A remission order is granted by the government rather than the Canada Revenue Agency, and is in effect a decision to waive amounts that are legally owed, not a settlement of any genuine legal dispute as to amounts owed. They are uncommon, and are typically granted only in cases of extreme hardship or unfairness. These orders are made under the authority of the Financial Administration Act, the relevant provision of which allows the government to remit any tax or penalty (including interest) when collecting the amount in question ''is unreasonable or unjust or [it] is otherwise

[1] *Certain Former Employees of SDL Optics, Inc. Remission Order*, S.I./2007-99, C. Gaz. 2007.II.2318, Nov. 14, 2007.

in the public interest to remit the tax.'' In this case, the remission order is stated as having been made ''in the public interest'' and ''on the recommendation of the Minister of National Revenue,'' who is responsible for overseeing the CRA.

The hardship faced by the former SDL employees is undeniable, and not many people would begrudge them their good fortune in successfully convincing the government to waive the amounts owing. In this case, it appears that the local Member of Parliament in whose riding many of the affected employees live, Minister of Natural Resources Gary Lunn, championed their cause and was primarily responsible for their success, overriding objections expressed by at least one senior CRA official.[2] As such, the relief provided for appears to have been obtained on a political basis rather than by reason of any change in tax policy.

The many other employee stock option holders who have experienced similar hardship under the law might well consider whether they too should be exploring the potential for relief. The issuance of the SDL remission order could reasonably be considered an inherent acknowledgment of unfairness or flawed tax policy in the existing law dealing with the taxation of stock option benefits. If so, it is unclear what basis the government has for not offering relief more broadly, with the appropriate response being a change in law affecting all taxpayers, instead of a political decision to provide relief only for a few. In any event, companies with employee stock option holders facing comparable circumstances as a result of a decline in their share price should consider what their options are for obtaining relief — something that would *really* generate employee loyalty. ◆

[2]*See, e.g.,* ''Tories Spell Relief,'' *Ottawa Citizen*, Dec. 6, 2007, *available at* http://www.canada.com/components/print.aspx?id=6693a664-a722-4f81-bf57-c05267354ece.