Stock options

How to factor taxation and risks into your financial plan

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Do you have stock options issued to you as part of your employment package? If so, you should be aware of how they are taxed and the risks associated with this type of compensation.

How are they taxed?

A stock option is essentially the right to purchase a share at a stipulated price for a stipulated period of time, no matter how high the share rises in value. Although this means that there is no limit as to how much profit options can generate, there are risks that can arise with stock options. One of the risks is the tax liability which is triggered at the time at which the options are exercised. When you exercise employee stock options, you will trigger a taxable employment benefit equal to the difference between the exercise price and the fair market value of the stock on the date of exercise. For example, if you are issued an option to purchase shares for $5 and the shares are worth $10 on the date the option is exercised, you will trigger a taxable employment benefit equal to $5 per share. Therefore, if you purchase 10,000 shares, you will have $50,000 in taxable income which you must report.

Is there any way to decrease the amount of tax I have to pay?

There are ways in which you can receive a 50% deduction of the employment benefit (note that the deduction may be less than 50% in certain cases in Quebec). This is dependent on a variety of factors, including the type of shares issued (common or preferred), the price of the shares at the time the option was issued, whether or not your employer is a Canadian-controlled private corporation and the length of time that you hold the shares.

Can I defer the tax until I sell the shares?

As you might expect, many individuals would find it difficult to pay tax on $50,000 (or even $25,000) of non-cash compensation. This is why in certain cases, the Canada Revenue Agency allows you to defer the tax on the employment benefit until the shares are sold. If you work for a Canadian-controlled private corporation or a public company, you may be able to defer the tax on the employment benefit if certain conditions are met. If you do not work for a Canadian-controlled private corporation or a publicly traded company, no deferral will be available.

What happens if the shares increase or decrease in value after I exercise?

If the shares increase in value, you will have a capital gain. Using our example, if you had shares which you purchased on a date on which they were worth $10, and the shares increased in value to $16 on the date you sold them, you would have a capital gain of $6 per share. Capital gains are only 50% taxable, so only $3 per share would have to be included in your taxable income. Using our example, if you sold all 10,000 shares, you would have $30,000 of taxable income (in addition to the $50,000 in taxable income which accrued on the date you exercised the option). The real problem, however, is if the shares decrease in value. If the shares go down to $6, then you will have a capital loss of $4 per share, 50% of which can be used against capital gains only. It is important to remember that the employment benefit is not a capital gain, and it will not go down in value even if the shares go down in value. Therefore, in our example, you will still have to pay tax on the $50,000 employment benefit (which may be reduced by 50% if you meet the conditions), even though the shares have decreased in value.

continued on next page

continued from previous page

It is important to remember that stock options can create a large tax liability, and you should ensure that you plan for this liability. As you can see, the taxation of stock options is very complex, and you should receive advice even prior to signing any agreement with your employer in which you are granted stock options.

So how should I factor stock options into my financial plan?

First of all, you should remember that investing in your employer is an investment like any other. Many individuals are lulled into a false sense of security when investing in their employer, and they feel the need to exercise every stock option they can. However, there have been some high profile cases where employees held all their investments in the stock of their employer and when their employer went bankrupt, they lost not only their jobs, but also their investment. When investing in shares of your employer, ensure that the investment fits within your asset allocation plan. You should have a properly diversified portfolio at all times, and the shares of your employer are only one component of that.

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