



ACCOUNTANTS FOR ENTREPRENEURS

TAX LETTER

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TAXATION OF EMPLOYEE STOCK OPTIONS AND UPCOMING CHANGES TAXATION OF SHAREHOLDER LOANS FOREIGN EXCHANGE GAINS AND LOSSES PATRONAGE DIVIDENDS OF AGRICULTURAL COOPERATIVES AROUND THE COURTS

TAXATION OF EMPLOYEE STOCK OPTIONS AND UPCOMING CHANGES

Currently, employee stock options are taxed preferentially under the Income Tax Act relative to other forms of remuneration.

There is no taxable benefit to the employee when the stock option is granted. Instead, the inclusion of the stock option benefit is normally deferred to the year that the option is exercised and the underlying shares are *acquired*. However, if the employer issuing the shares is a Canadian-controlled private corporation (CCPC), the inclusion of the benefit is deferred further to the year that the shares are *sold*.

The benefit included in income is the amount by which the value of the shares at the time they are acquired exceeds the exercise price paid when they are acquired. If the employee paid something for the option (which is rare), the amount paid reduces the amount of the benefit.

The more significant tax preference – more important than the deferral –, is the one-half taxation of the benefit. That is, although the benefit is included in income, a deduction of one-half of the benefit is normally allowed in computing taxable income.

As a result, the benefit is taxed at the same rate as capital gains, which are also only one-half taxed. However, as discussed below, the one-half deduction for employee stock options will be somewhat restricted, effective for options granted after June 2021.

In general terms, in order for the one-half deduction to apply to the stock option benefit, the following conditions must be met:

- The shares must be common shares, or “prescribed shares” that are similar to common shares;
- The employee must deal at arm’s length with the employer; and
- The value of the shares at the time the option is granted must not be greater than the option exercise price.

Alternatively, if the shares are CCPC shares, the one-half deduction can also be claimed if the employee holds the shares for at least two years. In such case, the above conditions do not have to be met. In general terms, a CCPC is a private corporation resident in Canada that is not controlled by non-residents or public corporations.

The amount of the benefit is added to the employee’s cost of the shares for capital

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gains purposes. This rule ensures that the employee will not be double taxed on the amount of the benefit.

Example

You were granted an employee stock option in 2019. The exercise price was \$10 per share and covered 1,000 common shares. The value of the shares when they were granted was \$10 per share. The employer is not a CCPC. You deal at arm's length with the employer.

You exercise the option in 2020 when the 1,000 shares are worth \$16 each. You sell the shares in 2021 for \$20 each.

Results: In your 2020 tax return, you will report the benefit of $(\$16 - \$10) \times 1,000$ shares, which equals \$6,000. Based on these facts, you are eligible for the one-half deduction, so only \$3,000 is included in your taxable income.

The cost of each share to you for tax purposes equals the \$10 that you paid under the exercise price plus the \$6 benefit per share, or \$16. Since you sold them for \$20 each in 2021, you will have a capital gain of \$4 per share. This results in a capital gain of \$4,000, half of which, \$2,000, is included in your income as a taxable capital gain in 2021.

Note: If the employer was a CCPC, both the taxable benefit and the taxable capital gain would be included in your 2021 tax return. Even though the shares were not held for 2 years, the deduction is available under the first rule described above.

Under current rules, the employer is not allowed a deduction in computing its income with respect to the stock option benefit. This rule is detrimental for employers compared to the payment of other forms of employee remuneration and compensation, which are generally deductible for the employer.

Upcoming changes

In the 2019 Federal budget, the government announced that it would be limiting the one-half deduction that applies to employees receiving stock option benefits. Draft proposals were released at the time, but the government delayed the implementation of the proposals pending further study.

Recently, in its Economic Statement on November 30, 2020, the government released the latest version of the proposals. They will apply to employee stock options granted after June 2021. The proposals do not apply to options granted before July 2021, even if they are exercised after that time.

Where they apply, the new rules will limit the one-half deduction to employee stock option benefits reflecting \$200,000 worth of shares per year for options granted in that year (the value is determined at the time of the grant of the option). Stock option benefits over that limit will be fully included in the employee's taxable income. However, for the amount fully included for the employee, the employer will normally be allowed a deduction in computing its income.

As a simple example, say you are granted an option in September 2021 to acquire shares in your employer corporation, which is not a CCPC. At the time of the grant, the shares

that are subject to the option are worth \$300,000. You exercise the option and acquire the shares in December 2021. Since the new limit regarding the one-half deduction is \$200,000, only two-thirds of your resulting benefit will be eligible for the one-half deduction. The other one-third will be fully included in your taxable income.

There are two significant exceptions, where the proposals do not apply and the one-half deduction continues to apply for the employee.

First, the proposals do not apply to stock options covering CCPC shares. In other words, any CCPC, regardless of size, can issue employee stock options and the employees can benefit from the one-half deduction.

Second, the proposals do not apply to stock options offered by other (non-CCPC) employers, generally if their gross revenue for accounting purposes for the most recent fiscal period is \$500 million or less (if the corporation is part of a group of corporations that prepares consolidated financial statements, the amount reported for gross revenues of the group must be \$500 million or less). Certain other conditions apply.

TAXATION OF SHAREHOLDER LOANS

When you take out a loan from a bank or otherwise, the amount of the loan is obviously not included in your income.

However, if you are a shareholder of a corporation and receive a loan from the corporation, the "shareholder loan rule" under the Income Tax Act applies such that the principal amount of the loan will be

included in your income, unless you fall within one of the exceptions discussed below.

Furthermore, if you are "connected" with a shareholder of the corporation, even if you are not a shareholder in the corporation, you can be subject to the shareholder-loan rule. You will be "connected" with a shareholder if you do not deal at arm's length with them – for example, if you are "related" to the shareholder under the income tax rules.

The exceptions

First, the shareholder loan rule does not apply if you repay the loan in full by the end of the next taxation year of the corporation following the year in which the loan is made. This gives you almost two years to repay.

For example, say your corporation has a calendar taxation year (ending December 31). If you receive a loan from the corporation in January 2020 and repay it by the end of December 2021, the rule does not apply.

However, this exception does not apply if the repayment is part of a series of loans and repayments. For example, if you repay the loan in December 2021 and the corporation lends you more funds in January 2022, this exception likely will not apply.

Second, the shareholder loan rule does not apply if the corporation gives you the loan as part of its ordinary business of lending money, and there are "*bona fide* arrangements" for you to repay the loan within a reasonable time.

A third exception applies if you are both a shareholder and employee of the corporation. This exception applies if:

- You are **not** a “specified employee” of the corporation, generally meaning you own less than 10% of the shares of any class in the corporation. For these purposes, you are deemed to own shares owned by non-arm’s length persons. For example, if you are an employee of the corporation and own 9% of a class of shares and your spouse owns 2% of the same class, you will be a specified employee; or
- Regardless of whether you are a specified employee, you use the loan to purchase a home, new shares in the corporation, or a motor vehicle to be used in the course of your employment.

Additionally, for this exception to apply, it must be reasonable to conclude that you received the loan because of your employment with the corporation rather than your shareholdings in the corporation, and there must be *bona fide* arrangements for you to repay the loan within a reasonable time.

Repayment of loan

If a loan was included in your income under the above rules, you can deduct any amount you repay to the corporation for the year during which you make the repayment. This deduction is not allowed if the repayment is a series of repayments and loans. Again, for example, if you repay the loan and the corporation simply lends you money again shortly afterwards, the deduction likely will not be allowed.

Deemed interest benefit?

If you fall within one of the exceptions, such that the shareholder loan rule does **not**

apply, you are not necessarily out of the woods. If the loan does not carry an interest rate that is equal to or greater than the “prescribed rate” under the Income Tax Act, you will normally have to include in your income a deemed interest benefit.

The deemed interest benefit for a taxation year equals the prescribed rate that applies during the year on the outstanding amount of the loan, minus the interest you actually pay on the loan within the year or by January 30 of the following year.

The prescribed rate is set each calendar quarter and therefore can change over the course of a year. The prescribed rate is currently 1%. The prescribed rate tends to be quite low, as is it based on Federal 90-day treasury bill interest rates, which are relatively low.

Example

You receive a \$100,000 loan from your corporation on January 1. You fall within one of the shareholder loan exceptions described above, so that rule does not apply. However, the loan is interest-free. You do not repay any of the loan in the year.

Suppose the prescribed rate of interest is 1% for the first two quarters of the year and 2% for the last two quarters of the year.

Rounding off to keep numbers simple, you will include in income:

$\$100,000 \times 1\% \times \frac{1}{2}$ (since the 1% rate only applied to the first half of the year) = \$500, plus

$\$100,000 \times 2\% \times \frac{1}{2}$ (for the second half of the year) = \$1,000.

FOREIGN EXCHANGE GAINS AND LOSSES

There are a few ways you can have a foreign exchange (FX) gain or loss.

If you do, you will have a taxable capital gain or allowable capital loss (unless you are in the business of trading foreign currency, in which case your gains and losses will be business income or loss).

Conversion / sale of foreign currency

As a simple example, you can have an FX gain or loss if you purchase foreign currency, and later sell it or convert it back into Canadian currency. Your cost of the foreign currency for Canadian tax purposes is the amount you paid for it in Canadian dollars. Similarly, when you sell the foreign currency or convert it back into Canadian currency, your proceeds of disposition equal your proceeds expressed in Canadian dollars.

However, the first CAN \$200 of net gains or losses per year are ignored and do not need to be reported for tax purposes.

Example

You purchase US dollars when the FX rate is $\text{US}\$1.00 = \text{C}\1.20 . In other words, you pay \$1.20 Can for each US dollar.

You later sell $\text{US}\$10,000$ when the FX rate is $\text{US}\$1.00 = \text{C}\1.30 , so you receive $\text{C}\$1.30$ for each US dollar. You will realize a capital gain of $\$10,000 \times 0.10$,

or \$1,000. This is your only FX transaction in the year.

The first \$200 is ignored. Half of the remaining \$800, or \$400, is a taxable capital gain.

Purchase and sale of property in foreign currency

If you buy a property using foreign currency, your adjusted cost base of the property for Canadian income tax purposes is your cost in Canadian dollars at the time of purchase. Similarly, when you sell the property in a foreign currency, your proceeds of disposition will be the proceeds expressed in Canadian dollars at that time. Therefore, you could have an FX gain or loss. The \$200 rule described above does not apply in this case.

Example

You bought some real estate in the United States for $\text{US}\$1$ million, when the FX rate was $\text{US}\$1.00 = \text{C}\1.20 . Your adjusted cost base for Canadian tax purposes will be $\text{C}\$1.2$ million.

You sell the real estate for $\text{US}\$1$ million, when the FX rate is $\text{US}\$1.00 = \text{C}\1.30 , so that your proceeds are $\text{C}\$1.3$ million. As a result, you will have a capital gain of \$100,000, half of which or \$50,000 will be included in your income as a taxable capital gain.

Note that if you sold the real estate for more than $\text{US}\$1$ million, your total capital gain would reflect the additional proceeds, a portion of which would include the FX gain. For example, if you sold the real estate for $\text{US}\$2$ million, when the

FX rate was US\$1.00 = C\$1.30, your proceeds of disposition would be \$C2.6 million. Your total capital gain would be C\$1.4 million, a portion of which includes an FX gain (the rest of the gain coming from an increase in the value of the corporation in US dollars).

Repayment of foreign currency loan

If you take out a foreign currency loan, the amount of the loan for Canadian income tax purposes is the Canadian dollar equivalent at the time of the loan. When you repay the loan, the amount of the repayment is similarly measured in Canadian dollars at the time of repayment. If the value of the Canadian dollar has changed in the meantime, you will have an FX gain or loss at the time of repayment. In this case, the \$200 rule discussed earlier does not apply.

Example

You took out a loan of US\$1 million, when the FX rate was US\$1.00 = C\$1.20. Therefore, the amount of the loan was C\$1.2 million.

You repay the loan when the FX rate is US\$1.00 = C\$1.30. Therefore, the amount of your repayment is C\$1.3 million.

In this case, you will have a capital loss of \$100,000, half of which or \$50,000 will be an allowable capital loss.

PATRONAGE DIVIDENDS OF AGRICULTURAL COOPERATIVES

When an agricultural cooperative corporation pays a patronage dividend, the recipient is normally required to include the dividend in

the year of receipt. The cooperative is required to withhold tax on the dividend.

However, if the dividend is paid in the form of additional shares of the cooperative, the inclusion of the dividend for the recipient is deferred to the year in which the shares are disposed of. Furthermore, the cooperative is not required to withhold tax when it pays the dividend in shares. Certain conditions apply (for example, normally the shares cannot be redeemable for at least five years).

This rule regarding dividends of shares was set to expire for shares issued after 2020. The federal government recently extended the rule to shares issued through the end of 2025.

AROUND THE COURTS

Grievance payment included in income

Most payments received in relation to your employment or loss of employment are included in your income.

However, a payment of damages for personal injury (for example, physical or mental injury or distress) is normally not included in income.

In the recent *Saunders* case, the taxpayers were employed as “team leads” at the Calgary Tax Services Office of the Collections Division of the Canada Revenue Agency (CRA). A new Director of the office was hired. The Director changed the overtime policy regarding team leads.

Previously, overtime was offered to team leads of all sections of the Collections Division. Under the new policy, overtime was offered only to team leads in certain sections, which did not include the taxpayers' section.

The taxpayers made multiple inquiries about the policy change and expressed their interest in working overtime on several occasions, but without success. Apparently, the Director's behaviour toward them was "bullying, aggressive, and harassing".

The taxpayers filed a grievance at the Public Service Labour Relations and Employment Board, arguing that they were arbitrarily and unfairly denied the overtime opportunities. The Board agreed and awarded them monetary damages.

The taxpayers took the position that the damages were for "personal injury" and therefore not taxable. The CRA disagreed and assessed the damages as income.

On appeal to the Tax Court of Canada, the Tax Court judge upheld the CRA assessment. The judge concluded that the damages represented amounts that the taxpayers would have received, had they been offered the overtime and accepted. Since the income tax treatment of the

damages took the character from those amounts that would have been received, they were fully included in income. There was insufficient evidence to justify their characterization as damages for personal injury.

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.