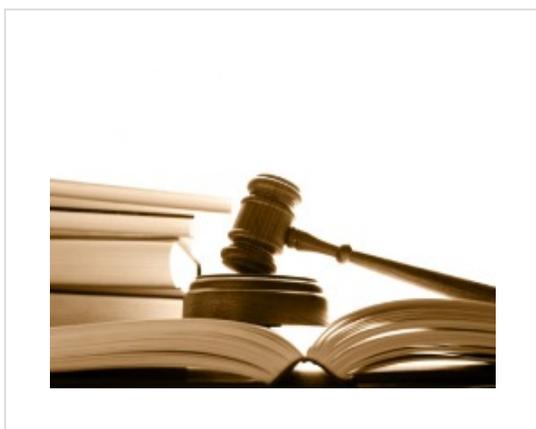


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PITFALLS WITH EMPLOYEE STOCK OPTION TAXATION

Jamie Golombek / June 23, 2017



Employee stock option taxation is tricky, and things get more complicated if the option price is denominated in a foreign currency. Take the recent case involving Natale Ferlaino, decided by the Federal Court of Appeal last month (*Ferlaino v The Queen*, 2017 FCA 105), which involved options denominated in U.S. dollars.

Before reviewing the facts of the case, which was an appeal from a prior Tax Court decision, let's review the general rules governing the taxation of employee stock options.

TAXATION OF EMPLOYEE STOCK OPTIONS

Under the tax rules, when a stock option is exercised, the difference between the amount paid for the shares (the exercise price or strike price) and the fair market value of the shares upon exercise is included in income as an employment benefit. For certain qualifying options, an offsetting deduction equal to one-half the benefit may be claimed. For an option on shares of a public company to qualify, the exercise price can't be lower than the fair market value of the underlying shares on the granting date.

Effectively, therefore, employee stock options are taxed like capital gains, although they are still considered employment income and thus qualify as earned income for calculating RRSP contribution room. But, because they aren't actually capital gains, you can't offset the income inclusion with capital losses.

FACTS OF THE CASE

Ferlaino was a senior employee of Pratt & Whitney Canada, a wholly owned subsidiary of United Technologies Corporation (UTC), a U.S. publicly traded company. As a senior executive, he received employee stock options to purchase UTC shares, which were offered through an incentive plan designed "to attract, retain and motivate senior employees of UTC and its subsidiaries."

One of these options entitles a participant to purchase shares of UTC at a specified price for a maximum period of 10 years from the grant date. Options vest three years after the grant date.

On December 1, 2000, Ferlaino received an award letter from UTC confirming he was granted 1,000 stock options at an exercise price of US\$35.25 per share. On February 4, 2002, he received a second letter confirming he was granted 500 stock options at an exercise price of US\$33.495 per share.

The UTC shares eventually increased in value, and, with the expiry dates approaching, Ferlaino decided to lock in his gains by exercising his options and then immediately selling his shares, using what's known as a cashless exercise. The net effect was that a sufficient number of treasury shares were issued by UTC, delivered to Ferlaino's broker and immediately sold. After the sell order settled, the broker issued a cheque to UTC representing the exercise price. The balance of the proceeds of sale [DASH] net of transaction costs [DASH] was forwarded to Ferlaino.

Ferlaino went through two cashless exercises: firstly, on April 26, 2010, when he exercised 1,000 stock options to acquire UTC shares at US\$35.25 per share; he then immediately sold them at US\$75.75.

Secondly, on January 25, 2012, he exercised 500 stock options to acquire UTC shares at US\$33.495 per share; he then immediately sold them for US\$78.60 per share.

THE TAXPAYER'S POSITION

In calculating his employment benefit, Ferlaino compared the fair market value of the shares upon exercise in U.S. dollars using the exchange rate on the exercise date, to the exercise price for those shares, using the grant price and the exchange rate on the grant date.

Thus, on the basis of his understanding that the option granting was one transaction and the exercise of options and sale of shares was another, on his 2010 tax return, he reported his employment income as follows.

	Result in U.S. dollars	F/X rate	Declared for 2010
FMV of shares upon exercise	US\$75,750.00	0.9991	C\$75,682.00
Exercise price	<u>US\$35,250.00</u>	1.53545	<u>C\$54,124.00</u>
Employment benefit	US\$40,500.00		C\$21,558.00

Using the same methodology, he reported the following on his 2012 return:

	Result in U.S. dollars	F/X rate	Declared for 2012
FMV of shares upon exercise	US\$39,300.00	1.013262	C\$39,821.00
Exercise price	<u>US\$16,747.50</u>	1.594012	<u>C\$26,695.00</u>
Employment benefit	US\$22,552.50		C\$13,126.00

In both tax years, Ferlaino calculated the exercise price with reference to the exchange rate in effect on the grant date, and calculated the FMV of the shares upon exercise with reference to the exchange rate in effect on the exercise date.

CRA'S POSITION

CRA reassessed Ferlaino for both 2010 and 2012 on the basis that he was required to report the actual cost of the securities acquired and converted into Canadian dollars using the exchange rate for the date the stock options were exercised.

As a result, CRA deemed the appropriate exchange rate on April 26, 2010 to be 0.9984, resulting in employment income of C\$40,435 for 2010. CRA also deemed the appropriate exchange rate on January 25, 2012 to be 0.9956, resulting in employment income of C\$22,453 for 2012. In both cases, CRA allowed the 50% stock option deduction.

These were the figures CRA said he should have reported:

	Result in U.S. dollars	F/X rate (April 26, 2010)	Declared for 2010
FMV of shares upon exercise	US\$75,750.00	0.9984	C\$75,628.80
Exercise price	<u>US\$35,250.00</u>	0.9984	<u>C\$35,193.60</u>
Employment benefit	US\$40,500.00		C\$40,435.20

	Result in U.S. dollars	F/X rate (January 25, 2012)	Declared for 2010
FMV of shares upon exercise	US\$39,300.00	0.9956	C\$39,127.08
Exercise price	<u>US\$16,747.50</u>	0.9956	<u>C\$16,673.81</u>
Employment benefit	US\$22,552.50		C\$22,453.27

TAX COURT OF CANADA RULING

The Tax Court judge reviewed the general rule that states that employment income and benefits, including stock option benefits, are taxed on a cash basis and must be reported in the tax year in which they're received. Employee stock options aren't taxable as an employment benefit until they're exercised. Citing prior decisions, the judge concluded that the appropriate date to quantify the stock option benefit is the exercise date, and therefore to use only the exchange rate for the exercise date (not both the grant date and the exercise date, as Ferlino did). The judge agreed with CRA and dismissed Ferlino's case.

FEDERAL COURT OF APPEAL

Ferlino appealed this 2016 decision to the Federal Court of Appeal, which released its decision last month. Agreeing with the Tax Court, the panel of three judges said that they had "not been persuaded that the [Tax Court] judge made an error in law in upholding the [CRA's] reassessments [...]. He correctly applied the relevant legal principles and case law relating to the taxation of employee benefits derived from stock options denominated in a foreign currency."

As a result, the taxpayer lost his appeal as well.

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