

More Options with Stock Options: Taking Stock

As we are working our way out of one of the deepest, darkest recessions in history, it is reassuring to see some light at the end of the tunnel.

A recent CRA administrative position related to employee stock options provided just that bright light for me.

Over many years of working with executives in a philanthropic advisory capacity, I have been struck by their commitment to charitable giving, not only in terms of their time but also in terms of financial support. However, opportunities to maximize tax benefits, especially through the exercise of employee stock options, are often overlooked.

The ABCs of STOCK OPTIONS

An employee stock option is a right, but not an obligation, to acquire a specified number of shares of his or her employer's company at a certain price (the "exercise price") during a predetermined period of time. The exercise price is almost always set at not less than the fair market value of the share at the date the option is granted. Stock options generally vest, or become exercisable, after a specified time. Once the options vest, the employee has the right to purchase the underlying securities at the exercise price. Typically, the employee stock option will expire after a specified number of years (e.g. 10 years). Thus, the executive will want to exercise the option prior to expiry if it has value.

When the market value of the underlying security is higher than the exercise price, the option is said to be "in the money". An employee would normally choose to take advantage of such options and exercise them when they are "in the money". Otherwise, they are "underwater." When an option is "in the money", and not yet vested, the value created is an incentive for the employee to remain employed with the company on a

long-term basis. When underwater, or after expiry, the option represents no value to the employee.

Taxation of Stock Options

When stock options are exercised, the difference between the stock's fair market value and its exercise price is considered a taxable employment benefit and is taxed as income but at the same rate as a capital gain.

This means that 50% of the difference is taxable as income. However if the stock is a publicly listed security and the stock or the proceeds of the stock sale is donated to a registered Canadian charity within 30 days of the exercise date (provided it is within the same calendar year) the tax is eliminated. It is important to note that while gifts of publicly listed securities must be donated "in kind" to a charity in order to qualify for the elimination of capital gains tax, when exercising stock options, the cash proceeds of the stock sale may be donated to charity and will still result in the elimination of tax on the employment benefit (subject to certain conditions).

Cashless Exercise of Stock Options

One of the challenges with stock options is that the employee has to somehow come up with the money in order to exercise the options (i.e. to purchase the stock at the exercise price). As such, many stock option plans have a "cashless exercise" feature that can help to alleviate that concern. A "cashless exercise" is the exercise of an option by the employee in a manner that does not require the employee to provide the cash to exercise the option before the exercise, but instead allows them to use the equity built up in the option (in other words, the difference between the market value of the underlying stock and the exercise price as a way to exercise the option) to pay the exercise price. For example, if the employee has options covering 1,000



shares of stock exercisable at \$1 a share, and the fair market value of the stock is \$2 a share at the time of exercise, then the employee can pay the exercise price out of the proceeds of the sale of the stock after it is sold. In this case the process works as follows:

Exercise: The employee confirms he/she wants to exercise and sell the shares on the Trade Date

Trade Date: 1,000 shares are sold at market for \$2.00 per share

Trade Date plus 3: Employee's brokerage account is credited with \$2,000 when the trade settles.

Exercise price to be paid by the employee is \$1,000 (1,000 shares @ \$1.00 per share) and this amount is deducted by the employee's payroll department from the proceeds of the trade in the employee's brokerage account. In addition the payroll department would deduct the applicable withholdings (CPP, EI and income tax).

Withholding Tax on Cashless Exercise

I was recently approached by an executive with a very noble objective. He wanted to do a cashless exercise of a set of stock options and to donate the entire cash proceeds after payment of the exercise price to charity. His objective was simple...to get the maximum amount in the charity's hands as quickly as possible. When the executive approached the payroll department of his company, he was advised that upon completing the cashless exercise of his options, the amount available for the donation would be net of the applicable tax, CPP and EI withholdings. Their procedures were following the CRA policies around statutory withholdings which provide that:

- a) If stock options are exercised and the stock acquired is donated to charity, no statutory withholdings need to be deducted and remitted.
- b) If the stock options are exercised, the stock acquired is sold, then statutory withholdings are required.

In other words, CRA did not have a specific policy dealing with the cashless exercise where proceeds are gifted to charity.

Since, in a cashless exercise, the stock is always sold, the payroll department indicated it should deduct the withholdings. The executive was planning to complete

this transaction in January 2010 and wanted the donation to include the amount which would otherwise be deducted and remitted on account of statutory withholdings. He did not want to wait until April 2011 to receive a refund of those amounts which he could subsequently donate to the charity to top up his donation. It was clear that the tax savings from the donation would more than offset the tax owed from exercising the option, so the deduction and remittance of the withholdings seemed unfair and unnecessary. After a lengthy discussion with the CRA Income Tax Rulings Directorate ("Rulings"), I received a verbal confirmation that the payroll department did not have to withhold tax if the proceeds were to be donated to charity. They were not prepared to put this in writing however.

A verbal confirmation did not satisfy the executive's payroll department, which took its fiduciary responsibility around statutory withholdings very seriously and they decided to have their own tax advisor speak to yet another person in Rulings. That CRA officer advised that they would have to withhold tax in this situation.

Determined to help this executive maximize his charitable gift, I contacted the original person that I spoke to in Rulings who put me in touch with someone from the CRA Trust department (the area responsible for withholdings). After discussions back and forth, including many e-mails, they confirmed that statutory withholdings would not be necessary in such situations but insisted that the employer be responsible for directing the funds to charity if they were not going to deduct and remit the withholdings. After I explained that the stock options "settle" in the employee's brokerage account, from which the employer has no authority to direct funds, CRA agreed to waive the withholding and remittance obligations provided the employee confirms in writing to the employer - in advance of completing the cashless exercise - that all of the cash proceeds will be donated to charity. After reviewing this written confirmation from the CRA Trust department of their position, the employee's payroll department felt comfortable with completing the cashless exercise without deducting and remitting the statutory withholdings and the executive was able to maximize his gift by donating the full cash proceeds of the cashless exercise to charity.

The Bottom Line

CRA has now confirmed in writing that for a cashless exercise of stock options where the underlying stock is publicly traded and the cash proceeds are donated to charity, no amounts on account of income tax, CPP, EI

are required to be deducted and remitted. There is a requirement that the employee must confirm in writing to his employer his intent to donate all of the proceeds (after payment of the exercise price) to charity prior to exercising the stock options.

The recent market decline has been challenging for charities. However, stock options granted during the period typically involved exercise prices very close to record lows. As the market recovers and these stock options begin to vest, many executives will have stock options that are “in the money”.

Donating the proceeds of a cashless exercise of stock options has just become a lot easier and very tax effective. So while the market decline has been tough on everyone, it appears that every cloud has a silver lining.

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