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TAX LETTER

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EMPLOYEE STOCK OPTIONS

Many readers are likely aware how these employee stock options work.

In general terms, if you are an employee and are granted a stock option from your employer corporation, you have the right (but not an obligation) to exercise the option and acquire shares in your employer's corporation at an "exercise price".

The exercise price is simply the amount you can pay, if you choose, to buy the shares. Depending on the terms of the stock option agreement, you could have 1, 2 or more years to exercise the option.
Obviously, you will not exercise the option if the shares are worth less than the exercise price. For example, if the exercise price is $20 per share and the shares are currently worth $16 per share, you will not exercise the option and buy the shares for $20, since you could just buy the same shares for $16 on the market. But if the shares are currently worth $25 per share, you might exercise the option, or maybe wait to see if they go up even more in value.

If the option expires because you choose not to exercise it, there are no tax consequences.

Assuming you do eventually exercise the option, the following is a summary of the relevant tax rules.

First, when the option is granted to you, no amount is included in your income for tax purposes. This is an exception to the normal rules that say if you receive a non-cash benefit from your employer, the value of the benefit is included in your income (there are other exceptions). Although not entirely clear, the reason for this likely stems from the difficulty, especially for private corporations, of valuing the option at the time of the grant.

When you exercise the option and acquire the shares, there is an employment benefit included in your income. Normally, the benefit is included in the year you *acquire* the shares. However, if your employer is a Canadian-controlled private corporation (CCPC), the inclusion is deferred to the year you *sell* the shares.

The amount of the benefit is the fair market value of the shares when you acquire them in excess of the exercise price. For example, if the exercise price is $20 per share and the shares are worth $25 per share when you acquire them, the benefit is $5 per share, which is recorded as employment income on your tax return.

However, in many cases you get a **one-half deduction** in computing your taxable income, which means the benefit is normally only half-taxed, similar to the taxation of capital gains. (There is a $200,000 threshold for this one-half deduction that applies in certain cases, discussed below.)

The one-half deduction rule, subject to the $200,000 threshold, applies if:

- The shares are common shares, or shares that are substantially similar to common shares (there is a complex definition under the Income Tax Regulations);
- The exercise price was not less than the value of the shares *at the time the option was granted*; and
- You deal at arm's length with the employer corporation, basically meaning that you are not related to the corporation for income tax purposes (such as if you, or you together with family members, control the corporation).

Furthermore, if the employer is a CCPC, you get the one-half deduction even if you do not meet the above criteria, as long as you own the shares for at least two years before selling them.

If you exercise the option, such that the benefit is included in your income, then the amount of the benefit is added to the adjusted cost base of the shares. This rule ensures that you are not double-taxed when you sell the shares.

Example

I am granted an employee stock option with an exercise price of $20 per share. I exercise the option when the shares are worth $25 each.

Later, I sell them for $28 each.

Result:

I have a $5 per share employment benefit, which is cut in half in computing taxable income assuming I meet the criteria discussed earlier.

My adjusted cost base of the shares becomes $25 (the $20 exercise price plus the benefit included in my income). So when I sell the shares for $28, I have a capital gain of only $3 per share, half of which is included in my income as a "taxable capital gain" (the normal rule for taxing capital gains).

Conversely, if I sell the shares for $22 per share, I would have a capital loss of $3 per share, and half of that would be an allowable capital loss (generally claimable only against taxable capital gains).

The $200,000 threshold

For options *granted after June 2021*, there is a restriction on the one-half deduction. When the restriction applies, the full amount of the stock option benefit over the $200,000 limit is included in taxable income, rather than one-half.

The restriction limits the one-half deduction to employee stock option benefits reflecting **$200,000 worth of shares per year** for options granted in the year, based on the value of the shares at the time of the grant of the option. Employee stock option benefits over that limit are 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 August 2022 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 $500,000. You exercise the option and acquire the shares in December 2022. Since the limit regarding the one-half deduction is $200,000, the first $200,000 should be eligible for the one-half deduction. The remaining $300,000 will be fully included in your taxable income.

There are significant exceptions, where these restrictions do **not** apply and the one-half deduction continues to apply for the employee regardless of the $200,000 threshold.

First, the restrictions 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 restrictions do not apply to stock options offered by other (non-CCPC) employers, generally if their **gross revenue** for accounting purposes for their 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 report for gross revenues of the group must be $500 million or less). Certain other conditions apply for these purposes.

In summary, employee stock option benefits continue to enjoy preferential tax treatment, subject to the $200,000 rule.

THE SMALL BUSINESS DEDUCTION

The so-called "small business deduction", though generally called by that name, is actually a tax *credit* because it reduces the corporate tax rates.

Generally speaking, the small business deduction reduces the tax rate for CCPCs on the first $500,000 of their income from active business carried on in Canada. The apparent rationale is to promote entrepreneurship and help small corporations that may not have access to bank loans and other forms of financing.

The federal tax rate on business income is normally 15% for Canadian resident corporations. (There are some situations where a much higher rate applies, such as for an incorporated employee – a "personal services business", discussed further below. There are also lower rates, such as a special reduced rate for a corporation involving in manufacturing zero-emission technology.)

The small business deduction reduces the 15% down to 9% federally. Each province then provides a parallel deduction, which varies by province. For example, in Ontario the combined federal and provincial small business rate is currently 12.2%, and in Alberta it is 11%.

A CCPC is a private corporation resident in Canada that is not controlled by non-residents or public corporations or a combination thereof. So, for example, if you are resident in Canada and own a private Canadian corporation that you control, it will be a CCPC. For these purposes, "control" generally means owning more than 50% of the voting shares in the corporation.

If you own, directly or indirectly more than one CCPC, the small business deduction must be **shared amongst the corporations** if they are "associated" with each other. The meaning of "associated" is fairly complex, but generally two corporations are associated if they are controlled by the same person or group of persons. They are also associated if one corporation controls the other.

So if the corporations are associated, you need to choose how to allocate the $500,000 amount.

Example

I am the controlling shareholder of two CCPCs.

This taxation year, one CCPC has active business income of $500,000 and the other CCPC has active business income of $300,000.

I have various options. For example, I could allocate the entire $500,000 to the first corporation and it could benefit from the small business deduction for the whole amount.

But I might allocate $400,000 to the first corporation and $100,000 to the other corporation, and those amounts would benefit from the small business deduction.

The rationale for this associated corporation rule? The government does not want you to double up, triple up, and so on, if you own or control various CCPCs.

Phase-out of deduction with taxable capital over $10 million

Since the small business deduction is meant to apply to "small" businesses, there is a phase-out of the deduction when the CCPC has more than $10 million in taxable capital (a technical term in the Income Tax Act, but it generally includes things like share capital, retained earnings and debt issued by the CCPC).

For many years until this year, the small business deduction was phased out starting when the CCPC had taxable capital in excess of $10 million and was totally eliminated once its taxable capital was $15 million or more.

Under recent proposed changes, effective for taxation years beginning April 7, 2022 or later, there is a slower and more gradual phase-out. The deduction is still phased out starting when the CCPC has taxable capital over $10 million, but the phase-out occurs between that amount and $50 million of the CCPC's taxable capital so it is less severe than the previous rules.

The Department of Finance provides the following examples:

- a CCPC with $30 million in taxable capital would have up to $250,000 of active business income eligible for the small business deduction, compared to $0 under current rules; and

- a CCPC with $12 million in taxable capital would have up to $475,000 of active business income eligible for the small business deduction, compared to $300,000 under current rules.

When the small business deduction is not available

There are a couple of exceptions where your CCPC is not eligible for the small business deduction even if you can show that is carrying on a business.

First, the deduction does not apply if your CCPC carries on a "personal service business". Basically, this means that you or a related person, as an employee of the CCPC, provides services to a client or customer and, but for the existence of the CCPC, could be considered an employee of the client or customer. (This is also called an "incorporated employee".) For example, if my CCPC has a services contract with one client only and I could otherwise be considered an employee of the client (based on court decisions, which we will discuss in a subsequent Letter), my CCPC might not be eligible for the small business deduction, but it all depends of the facts. There are a couple of exceptions – the main one applies if the CCPC employs in the relevant year more than 5 full-time employees. (As noted earlier, a personal services business is not only ineligible for the small business deduction – it actually pays a much higher federal corporate tax rate, 28% instead of 15%!)

The small business deduction also does not apply if your CCPC runs a "specified investment business". In general terms, this can include a business the principal purpose of which is to derive income from property (e.g. interest, dividends, rents and royalties). An exception applies if the CCPC employs in the year more than 5 full-time employees. Of course, in many cases income from property is not a business in the first place, and would not be eligible for the small business deduction because it's not "active business income".

If your CCPC does not have more than 5 full-time employees and you are concerned about these rules, it is best to speak to your professional tax adviser.

THE GENERAL ANTI-AVOIDANCE RULE

There are many anti-avoidance rules under the Income Tax Act. Most of them are "specific" anti-avoidance rules because they target specific tax avoidance schemes and transactions. For example, the income attribution rules prevent you from splitting income with your family members in certain circumstances. (We have discussed the income attribution rules before and will summarize them again in a future Tax Letter.)
On top of those specific rules, there is a general anti-avoidance rule (GAAR), which can potentially apply to any transaction or event that circumvents the general scheme and intent of the Income Tax Act.

If GAAR applies, the results of your transaction or scheme can be re-characterized to whatever is "reasonable in the circumstances", which means you will pay more tax than you planned. The Canada Revenue Agency, or ultimately the courts, can use this rule to reduce a deduction, increase an inclusion, or reduce a credit, and they can use the rule for other detrimental purposes for taxpayers if GAAR applies.

So when does the GAAR apply?

First, there must be an "**avoidance transaction**". This means a transaction or event that results, directly or indirectly, in you receiving a tax benefit – which can include, among other things, an additional income inclusion, a reduction in your deductions, or more generally a reduction in your tax payable (including future tax payable, under a proposed amendment to GAAR that will apply retroactively). But the transaction is *not* an avoidance transaction if you can show that the transaction or event was undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit. Generally, if you can show that the transaction or event was primarily for business, investment, or personal purposes, and not to get the tax benefit, you will not be subject to GAAR.

An avoidance transaction also includes a transaction or event that is part of a series of transactions or events, where the series results in you receiving a tax benefit. This rule significantly broadens the concept of an avoidance transaction, because even if the transaction itself does not result in a tax benefit, if the series results in a tax benefit, you can still get caught under GAAR. Again, there is an exception where GAAR does not apply, in that the transaction is not an avoidance transaction if you can show that the transaction was considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.

Luckily, there is also an overriding provision. It says GAAR applies only if the transaction or scheme results in a "**misuse**" of specific provisions of the Income Tax Act or other tax laws, or an "**abuse**" of those rules.

On the downside, this "misuse or abuse" provision is difficult to interpret in many situations, and requires a tax lawyer or other tax expert to provide guidance. And even then, if the case eventually makes it to the courts, it is up to the judges to decide on whether GAAR applies.

WORKING ON COMMISSION? YOU CAN GET MORE DEDUCTIONS THAN OTHER EMPLOYEES

In most cases, employees get very few deductions in computing their employment income.

Conversely, if you are self-employed, meaning that you carry on a business, you are eligible for more deductions.

If you are an employee **paid by sales commissions**, you fall somewhere in the middle. First, you are entitled to deductions available to other employees, which can include, among others:

- Car expenses for work use like gas, oil, minor repairs and maintenance
- Travel expenses for work, including one-half of meal expenses when out of town for at least 12 hours
- Union or professional dues
- Supplies, including home office expenses like maintenance, rent, heat, and utilities (pro-rated based on the size of the home office relating to the home as a whole)
- Contributions to your employer sponsored registered pension plan
- Financing charges for a leased or purchased car for work, and tax depreciation on the car

If you are a **commissioned employee**, you can deduct additional expenses as well. They include:

- 50% of meals and entertainment spent on clients or customers
- Advertising and promotional expenses
- Additional home office expenses, such as property tax and insurance (again, pro-rated based on the size of the home office)

However, there is a bit of a catch, which is not actually detrimental in most cases.

As a commissioned employee, many of these deductions are generally **limited to the amount of your commission income**. However, if your car and travel expenses exceed your commission income, you can deduct those expenses in full, but not the additional expenses mentioned above.

Example

I am a commissioned sales employee.

This year I incur the following work expenses, pro-rated where appropriate:

- $25,000 car and travel expenses (other than financing charges and tax depreciation)
- $4,000 home office supplies
- $8,000 advertising and promotion
- $3,000 property tax and home insurance

These expenses total $40,000.

So if my commission income for the year is more than the $25,000 car and travel expenses, I would claim as many of the deductions as possible, up to my commission income.

But if commission income was, say $23,000, I would claim the $25,000 car and travel expenses, because otherwise I would be limited to the $23,000 commission income.

As for all employees, you are required to have a Form T2200 from your employer, certifying that you are required to incur these expenses for employment purposes.

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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.