BDO Canada

CROSS-BORDER TAX PODCAST SERIES

Episode 18: The use of stock options in buy/sell transactions – LIVE in Toronto

Debra Moses:

Mic test, mic test. Ready?

Hi, this is Debra Moses and you are listening to BDO's Cross-Border Tax Podcast live.

Thank you, this is a little bit different what I'm going to talk about, I just have to make sure I'm turning this right.

So, I'm using the term here stock options, which is kind of a general term, but it gets confused a lot. And I work in a global environment, so I tend only to do something when there's another country involved. So, I'm brought questions and they say, "Oh, we have stock options and we're going to change it." And it's like, "Okay, is it stock options? Just because it says it on the paper doesn't mean that it is," because you have to look at what is that actual plan. So, when I'm dealing with a foreign country, it doesn't necessarily follow the Canadian rules, so I always have to go through it.

I get brought in on a lot of transactions, because you've seen it a lot a couple of years ago where there were a lot of PE companies buying out a lot of buy/sell shares going on, and then it slowed down a little bit, but now it's picking up again. We're finding that I'm getting these questions a lot. And it tends to be something that's asked or thought of at the last minute just before the deal's closing, usually a couple days before the deal's closing, and I've been trying to bring attention to the fact that this is the owner's money that you're dealing with and they're kind of wanting to make sure that they get the most money that they can when any of these deals, when you're buying or selling a company. So, it's really important to look at it upfront because they do get offended if it's not done properly, as any of us would if that happened.

So, I'm going to talk, because I'm not sure who's got a lot of experience in it, but I'll just explain the two types that we have here in Canada of stock options, but that's what I'm talking about here right now. But any equity comp may not have stock options in it. It could be RSUs, there's all different types that can be done. So, when I'm going through it, I'm going to talk a little bit about CCPCs, just so that people understand the difference between that and a non-CCPC and just some little examples, different things that I've seen in my years of doing this, as well as some of the international transactions that I've seen and some of the different country variants that we've seen as well. You'll get a copy of the slides so you can see through some of them in case I don't get to all of them, and then just some additional considerations of what we're seeing in the marketplace and what companies are trying to do.

So technically, on a CCPC, some of you may know but just so that we're all on the same playing field, at grant date there's no tax implications, at vest date, there's no tax implications. I'm talking for Canada only here. On the exercise date, there's no tax implications assuming that the person that we're dealing with is an arm's length employee. So, on the date of sale of the shares that they've exercised these options for, the employment benefit is equal to the fair market value of the shares acquired at the time of exercise, less any strike price that's paid for them. That's what gets subject to tax as basically employment income.

Capital gain or loss can also rise on the difference between the proceeds received and the fair market value of the shares on the date of exercise because in this case, the benefit that happens gets deferred until the date of sale. So, you could have a drop or an increase in the price. The benefit will still get subject to tax on that date of sale depending on what the fair market value of the shares were on the date of the exercise. However, if it's dropped since then, the individual would have a capital gain or loss, capital loss if it's dropped, if it increases, they have a gain. And the thing is what some people don't get is that those capital losses can't be offset against the employment income that is also realized at the same time. So that's kind of how CCPCs work and they're slightly different and they're special to Canada is what it is.

So, with CCPCs, the thing that people tend to want stock options, and that's why you hear this word a lot, is because in Canada we have this special rule with a

50% deduction that only 50% of this benefit gets subject to tax in Canada.

So, there's two methods of getting it, so the employee deals at arm's length with the employer and has held those shares for at least two years. This is for CCPCs and it's under a different section in the act. If the employee deals at arm's length with the employer and that the shares are what we call prescribed shares, they're generally similar to a common share, and the exercise price is equal to at least fair market value of the underlying shares on the date of grant. So that's a second way. So, if you have a CCPC, you can meet it one of those ways depending on what it is.

So, for CCPCs, there's no payroll withholding income tax, CPP or EI required in respect of the employment benefit. There could be employer health tax and other payroll taxes that are payable on the stock option benefit, and the stock option benefit and 50% deduction if applicable are reported on T4 in the year sale. So that's just kind of the basics of how stock options are taxed when they're CCPC.

So some of the transaction considerations that you have to think of when you're doing this if you're buying or selling a CCPC is you have to look at, okay, these options are granted at less than fair market value, for example, so it would not result in a 50% deduction upon concurrent exercise and sale because you remember before this doesn't happen, they don't get that benefit until they actually sell the shares. So, if they do an exercise in sale, they're not going to meet the 50% deduction for CCPC because they weren't granted at fair market value.

But there's different ways that we've looked at on some of the transactions on how to get it because a lot of the companies that get bought up, especially by private equity and law, tend to be CCPCs. So it's like, how can we help these owners get the best out of the deal? So, one way that can be done is you can look at, can we roll these options over into the new entity? Or do we exercise the options and then roll the shares over into the new entity? So, there's two ways of looking at the transaction depending on it.

Now I have to step back and say I'm not a corporate person. I can deal with the equity side of things and how to do it, and I have to work very closely with the corporate tax people, international people, when we're doing these types of deals and reviewing the transaction, I look at just how are they dealing with the equity compensation.

So, if you're doing a rollover of options, the existing options can be exchanged for options into the new entity. If certain conditions are met, the new options can be treated as a continuation of the old options, meaning they get the same CCPC treatment that you had before, because the one thing that they want to do is they don't want to have these options with the benefit being taxed differently than what they had before. So, you need to ensure when you're doing it that in the money amount of the new options is the same as the old, that you're not giving any beneficial treatment to them basically. So the exchangeable shares might not qualify. So, in some transactions what you might have is they might want to exchange the shares in it, and then what can happen is maybe those shares that we're trying to do the exchange for don't meet the prescribed share rules and they can't get the 50% out of either one of them. So, we have to be careful of this.

So, it's just different things that we look at when we're trying to do a transaction and make sure that it's tax efficient for everybody and it makes everybody happy, they're getting the most money out of it.

So, let's say we have a CCPC going public and they're going public into the US, they're going on an IPO. So, there's going to be an exchange code, which is Canadian company between the CCPC and the ultimate US Parent Co. that it's going to go to. They have Canadian resident option holders, they have no desire to cash out those option holders and they will use exchangeable shares for Canadian rollover purposes for the existing shareholders.

So, in this example, can we roll over the options into exchange code for Canco? And like I said, the point there is that we need to determine whether or not the exchange code shares meet the prescribed share test on the exercise of the new option. And this is a point in time test, it's on the day of exercise that whether or not that can be done.

If they do not qualify, then you can consider rolling those options into the US Parent Co., like going from the CCPC straight up to the US code passing the exchange code. You can do that because in the Income Tax Act, there's no definition that says that you can't, there's a geographical region. So, you can go from Canada to the US when you're doing these rollovers, which sometimes people don't get that part of it. Rollover provisions would be met in this case, so therefore there is a deferral of taxation on the benefit from the CCPC. They still maintain that benefit, deferral of the benefit, until they actually sell those shares. So that's something a lot of them want to do because they don't have the liquidity to pay the tax on that because they don't get that until they sell. In this case, what you want to make sure is they want to look at, can we maintain that deferral of the benefit of the employment income on the CCPC share to the time when they actually sell the share so that they have the liquidity to pay?

So, what happens if we find out that there's a key option holder that's not dealing at arm's length with Canco? So, in this case, there's no deferral of taxation on the benefit until the sale because they don't qualify for it. A tax will arise on the exercise of the options, and there's no 50% deduction available either because they're not dealing at arm's length. However, if you roll the options, this will defer the taxation until exercising the new options in the US Parent Co., which can be concurrent with the sale of the share so that you'd have to do the exercise and the sale at the same time.

This would allow the option holder to have the liquidity to be able to pay the tax and any strike price, but they won't get any 50% deduction so they're paying on 100%. This will solve one of those issues, but not both. And we found this in a few transactions where people haven't really noticed that. And one of the things when you are looking at these buy/sell transactions is that you want to take the cap table and make sure that it's clean before you start into this transaction. You want to look at, okay, do you have somebody that might not be dealing at arm's length or not? And try and fix your cap table before you get into a transaction.

So, the other thing is what if you exercise options and then roll over the share requirements? So, in this case, options are exercised and generating benefit under 7(1.1). Taxation of the benefits is deferred until the disposition of those exchanged shares. And exchange of shares for shares in a new entity would normally result in a disposition, but the benefit can be deferred if certain provisions are met and that's under 7(1.5). So, you need to ensure, in this case, very similar to the rollover options, but the thing is the benefit has to be the same. You can't be giving somebody more value than the old shares, the new shares have to have the same value as the old shares. So, it's the pro rata that you have to be careful of and you have to also be careful if you're dealing with different currencies. And the taxable benefit will still get deferred because in 7(1.5) it says that they maintain the same conditions.

So, it also starts a two-year holding period for the 50% deduction at the time of exercise and the employment benefit does not change. So therefore, like I said earlier, any drop in the share value post-exercise will be a capital loss. You need to consider cashflow in this case because you're going to have to fund the exercise price and they're not selling anything so you have to be careful of that.

So, in this case, if we have Canco acquiring additional funding from a US Co. for the ownership stake, so it's somebody trying to get more funding, so some shares will be purchased in a secondary sale while others will be rolled into a new entity. So, some existing shareholders that have acquired their shares via an exercise of a stock option, for those shareholders selling in the secondary sale, they need to determine whether the 50% deduction will be available or not. So, it's the same tests that'll have to be looked at.

Employment benefit generated based on the fair market value at exercise less the option price of the individual pace.

So, there'll be a capital gain that'll arise on the proceeds, receive less than fair market value of the shares of the date of exercise. You could also look at whether you can get a long-term capital gains exemption, it might be available against any capital gain, but not the employment benefit.

And for rollover shareholders, you need to determine whether you can get a deferral of the benefit of taxation or not.

And the taxation and the stock option benefit can be deferred, like I said, on 7(1.5), and then the capital gain can be deferred under 85(1).

So those were CCPCs and they tend to be a little bit more complex because of the deferral or the benefit that can happen in that, then they have the two ways that they can get the 50%.

But for a non-CCPC, the grant, again, there's nothing, invest there's nothing, however this is where it's different is on exercise. The employment benefit is equal to the fair market value of the shares acquired less anything that's been paid for them. And on the date of sale, again, it's a capital gain or loss depending on the difference between the proceeds they receive and the fair market value of the shares on the date of exercise. So, if the shares have dropped in value from exercise to sale, it'll generate a capital loss and the capital losses can't be offset against employment income.

So, with this non-CCPC, you only have one way that you can get the 50% deduction. So in this case, the employee deals at arm's length with the employer, the shares have to be prescribed shares, generally common shares like I mentioned before, and the exercise price has to be equal to at least fair market value of the underlying shares at date of grant. So, you don't have a choice of the two.

So, it's taxable on exercise, therefore no ability to defer taxation of the option benefit even if the shares are rolled over. For practical purposes what often happens in transactions and buy/sells here is often the options get cashed out.

One thing that you have to be careful with here, and I've run across very recently on something like this, is a lot of countries are coming into Canada and they're testing the market. So, what they do is they set up operations here using what's called a professional employee company organization, a PEO or an EOR, an employer of record. And these are not something that's very easy to talk about without going into a long conversation, but you need also to look at the contracts that they have. Nine times out of 10, most of the contracts that I've seen, they will not touch equity comps. So, they tend to become and deal with all of the payroll withholding, any type of HR issues that you needed dealt with for the company. But when it comes to equity, they push it back to you. But then there's issues in Canada that some of these, we're having to work with labor lawyers to determine who is the ultimate employer. So, I mean, are you actually giving stock options to your employee or is it not your employee? Do they become an employee of the PEO?

So, when you're looking at this, we've had companies come in and they say, "Okay," and they don't tell you right away, but you have to kind of figure out what's happening. They're saying, "We're selling but we want to clean up the cap table and we want to get rid of some of the shareholders that are on there, and what are we going to do with these stock options?" And when you find out that actually these employees are actually employees of the PEO, well they're not your employee and how can you grant them stock options? And it gets complicated, but the best way to go about it and the way that I've seen is you just cash them out and then it's the PEO that's having to withhold from a bonus type payment as opposed to not exercising those shares, because if the person's not your employee, how can you grant them stock options and how can you do anything with the payroll?

So, this is a new thing that in the last couple of years a lot of the equity comp people that I work with, we've had a lot of questions about it with the labor lawyers trying to figure out what's going on with that. So, it's very important that if you're looking at buying a company or if you're selling a company, find out if they're using a PEO or an EOR, and then dig a little bit deeper. Have your lawyers look into it and see how it is because you can run into problems there.

And I could tell you that in the US they're very commonly used and every country has different rules around them, so they're not necessarily set up to work in Canada. Not saying they don't, I'm just saying that for the purposes when it comes to equity comp, it gets a lot more complicated. So that's why cashing out is the simplest way for them to be able to resolve certain issues because sometimes I get a, "I just need to talk to you for two minutes," and that was a question that I got a couple of weeks ago in a two-minute conversation that I'm like, "No, there's a lot more complexity in this question," as we all know as tax people here.

So, in this case if they cash it out, the 50% deduction may still be available and that's if the employer elects not to claim the corporate deduction. And of course, by doing that, they have to do the T4 reporting on it to make sure that they're doing the election.

And you need to ensure that the transaction documents do not violate the prescribed share tests or anything that will prevent the person from getting that 50% deduction.

And that's why it's important that we, because I'm always dealing with another country, I'm always having to see how it's been written because a lot of times what ends up happening is it's written for that country's rules, not for Canada, and it could take them offside and any Canadian being bought out by another country, they're looking for that, knowing, "Okay, I only have to pay tax on 50% of my benefits," so they want to want to keep that. It's important to them.

So, I just put a chart in here that you can look at when you have the slides. It's just sort of comparing the two of when the taxation is, whether a rollover works or not, and the types of deductions. Some of the international aspects of transactions that I've found that I've had to look at is it's important to consider implications where employees are located in different countries. So, it's like, what's the income tax treatment for those employees? Are there any employer payroll obligations? And any other additional requirements that may need to be done? I get questioned all the time when foreign companies are coming into Canada and they all poo-poo our payroll withholding requirements here in Canada. And I say, "If you don't want to do anything, you most likely will get caught," because the way that we report our income, as you know, on a personal return is there's line 101 and 104. 104 means it's employment income not reported on a T4, and it's very easy to pick up for audit purposes.

So, for US taxation of stock options, it depends on whether the options are ISOs are what they're called, Incentive Stock Options. So, there's an extensive list of specific criteria for them to meet an ISO. Basically, the exercise price has to be equal to fair market value on date of grant, there has to be stockholder approval and the annual vesting limit for those is 100,000 US dollars. If you don't meet that criteria, then it's called what is a non-qualifying stock option. So, it's very hard for Canadian plan to meet ISO, they're usually not qualified.

So, what happens with an ISO taxation? Grant date, nothing. Vest date, nothing. Exercise, there's no tax implications, but it could generate AMT for the individual. Date of sale, as long as the holding period is met, the entire benefit equal to the fair market value of the shares at disposition less strike price is subject to tax at a capital gains rate. So that's why they're beneficial. They're kind of like how I try to say in ISO, they're very different from our stock option plans when we can get the 50% deduction, but they're kind of like their special treatment that they get versus what we have here in Canada.

So, the employer obligations, there's no payroll withholding, income tax or social security required in respect to the employment benefit that's realized.

And the stock option exercise is reportable on a form 3921 in the year of exercise.

No corporate deduction for the employer unless it's a disqualifying disposition.

So, for non-qualified stock options, again, grant, vest, nothing, exercise price, the employment benefit arises equal to the fair market value of shares at exercise less strike price, very similar to how we do it in Canada for CCPC. And date of sale, same thing as what happens here in Canada.

So, for payroll withholding it is required, similar to in Canada here, so they're very similar to the way we do things there.

Taxable benefits reportable on form W-2, which is the US equivalent of a T4, and the corporate deduction for the employer is equal to the taxable employment income for the employee.

So, if we have a sale of Canco, a CCPC with subs in the US, UK and Denmark, stock options are to be exercised immediately prior to the sale. The execs can roll over part of their settlement into shares of new code.

So, in Canada, an option exercise is taxable under seven, as we talked about before, the benefit might be able to be deferred, no withholding required, T4 required in for year of sale and it could be subject to EHT as well.

In the US it's non-qualified, so it's taxable on exercise, withholding required on exercise, W-2 reporting and deferral of option benefit on rollover may only be available under limited structuring that could be done.

So, the UK, option benefit is taxable on exercise, withholding is required on exercise, and a P60, which is T4 equivalent, is required for a year of exercise. So additional annual employment related securities return is required. Various countries have introduced different types of reporting that has to be done by the employer when they're doing exercises. And there's no deferral on the option benefit for rollover into the new code.

From Denmark, option benefit is taxable on exercise, there's no withholding on exercise, employer income reporting is required and there's no deferral on option benefit.

So, it's just the way that different countries deal with things, it's important to look at it and not assume, and I know most of you probably don't, but a lot of countries do when they're coming in or some of the transactions do, we have to look at the different countries and how they're being dealt with.

One of the ones that we're seeing a lot of now is US profits interest, it's very big in the US. They have different code sections that they're dealing with on it, but these are units that are issued by a flow through entity for US purposes, usually a US LLC. It's a separate class of units providing entitlement to future growth. And there is a vesting period for. So it is, like I said, structured in line with some IRS rulings. There's no taxation on grant or vesting, the income and gains flow through to the unit holder.

So, for Canada though, these things become a little bit of a nightmare because the US LLC is treated as a corporation by the CRA, the LLC units are therefore considered securities for Canadian tax purposes and therefore taxable under section 7, which is the stock option benefit section.

Attributions of ownership usually present at the time of award, therefore is taxed similar to how a restricted stock award is taxed in the US, meaning that upon sale of the units capital gains treatment applies. But the issue is because you're giving something to the employee, what value is it at that time? So, it becomes a valuation issue. How do we value these? For Canadian tax purposes that's what it's.

So, we have to talk to our US colleagues whenever we get these in, and they are very common that we do see them here, we have to look at it because the timing of the taxation is different and the way that they're taxed are different.

So other considerations, cashflow, disadvantage and upfront taxation, LLC ownership not efficient from a US tax perspective. There's very limited CRA guidance on these right now, probably because they're so new. I think that they're probably going to end up coming up with some position that they'll take on them, and there's a lot of foreign reporting on these ones as well.

So, I know my time's coming up here, so I'm going to go, considerations are potential and equitable tax results between Canadian and non-Canadian employees. So, whenever you're trying to buy something out and you're a global company, you've got to make sure that you're treating all your employees properly, the same way, and that you're not giving more of a benefit to one than the other.

And one thing in the US that has is 409A and the related valuation requirements there. So 409A, you can kind of consider it like our SDA rules, our salary deferral rules. But the 409A has much stronger penalties in the US than our salary deferral arrangements.

Disclaimer:

This podcast was recorded live in Toronto, Canada on October 12th, 2023.