Incentives and Benefits

This regular feature is edited by Dov B. Begun of Osler, Hoskin & Harcourt LLP. It examines major trends and tax planning issues pertaining to executive incentive and benefit plans and arrangements.

CROSS-BORDER STOCK OPTIONS

Allocation of Benefits Arising From Cross-border Stock Options: a Shift in the Position of the Canada Revenue Agency

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Introduction

In today's global marketplace, it is not uncommon for an executive of a multinational corporation to live and work partly in Canada and partly in another country for portions of his or her career. Such an executive may, in the course of his or her employment duties in Canada, be granted stock options.[1] Where that executive then moves to a foreign jurisdiction prior to the exercise of the stock options, the question arises as to which jurisdiction – Canada or foreign – should have the first right to tax. Further, where the jurisdictions do not agree on the appropriate sourcing methodology, the executive may be left in the unenviable situation of being subject to double tax. The purpose of this article is to outline Canada's approach to the allocation of stock option benefits in such a scenario, having regard, in particular to the recently announced shift in the administrative position of the Canada Revenue Agency (the "CRA").

The provisions of the Income Tax Act[2] are silent as to the appropriate allocation methodology, except for the basic rule in subparagraph 115(1)(*a*)(i) that the income from duties performed in Canada are to be included in computing the non-resident person's taxable income earned in Canada, and, where that person was resident in Canada at the time of performing such duties, income from duties performed outside Canada is also to be included.[3] Such amounts are which is then subject to tax under the Act pursuant to paragraph 2(3)(*a*). Similarly, most of Canada's tax treaties – with the notable exception of the *Canada-United States Tax Treaty* (the "U.S. Treaty") – are silent on this issue, although it is generally accepted that stock options are governed by the "Income from Employment" provision of tax treaties.

The issue of the appropriate apportionment of stock option benefits where an individual is granted a stock option at a time he or she is employed in Canada but then moves from Canada prior to the exercise of the option was considered in *Hurd v. The Queen*,[4] wherein the Federal Court of Appeal held that the non-resident optionholder was subject to taxation in Canada, pursuant to paragraph 7(1)(*a*), in the year of exercise. The issue of apportionment can also arise where, for example, a U.S.-resident individual is granted options while employed in the U.S. but then immigrates to Canada prior to the exercise of the option. This scenario arose in *Tedmon v. MNR*,[5] wherein the Tax Court held that the

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[1] For the purposes of this article, references to stock options contemplate agreements to issue shares, which are governed by section 7 of the Act.

[2] R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act." Unless otherwise stated, statutory references in this article are to the Act.

[3] Note also that, by reason of paragraph (*c*) of the definition of "excluded right or interest" in subsection 128.1(10), stock options are not subject to deemed disposition at the time of emigration.

[4] 81 DTC 5140 (F.C.A.). See, also, *Hale v. The Queen*, 90 DTC 6481 (F.C.T.D.), aff'd 92 DTC 6473 (F.C.A.).

[5] 91 DTC 962 (T.C.C.).

taxpayer should be taxed pursuant to paragraph 7(1)(*a*) even though the options were not related in any way to his employment in Canada. The appropriate application of Canada's tax treaties in either circumstance has been the subject of debate and the CRA has previously recognized the possibility of double taxation in scenarios where both Canada and the other jurisdiction assert their right to tax, suggesting that competent authority relief ought to be sought.

CRA Position

Based, in part, on the comments in the *Hurd* decision, the CRA's long-standing administrative position has generally presumed that an employee stock option benefit is attributable to services rendered in the year the option was granted, subject to compelling evidence to suggest that some other period is more appropriate.[6] On the basis of this "grant period approach," an executive who is granted stock options in a particular taxation year is subject to tax on the portion of the stock option benefit attributable to Canadian services in the year of grant, regardless of when the option is exercised. Thus, where the executive fulfilled all of his or her employment duties in Canada in the year of the grant, 100% of the resulting stock option benefit would be subject to tax in Canada. Where the executive worked partly in Canada and partly in a foreign jurisdiction in the year of grant, the stock option benefit was to be allocated to Canada based on the total number of days of Canadian service divided by the total number of days of service in Canada and abroad.[7]

The foregoing allocation methodology was contrary to the allocation methodology used by various other countries (such as the United States) and was also contrary to the method accepted by the OECD.[8] In particular, the OECD Commentary provides the following governing principles:

- the determination of whether and to what extent a stock option benefit that is derived from employment exercised in a source country is to be done by examining all relevant facts and circumstances, including the contractual conditions associated with the option such as vesting conditions;
- a stock option benefit is generally presumed not to relate to services rendered after the vesting period. For this purpose, the vesting period is to be distinguished from a situation where an option has vested but is subject to forfeiture if not exercised within a specified period;
- a stock option benefit is generally presumed not to relate to past services, unless there is evidence to suggest that, in the circumstances, past services are relevant; and
- a stock option benefit is apportioned to each source country based on the number of days of employment exercised in that country over the total number of days in the vesting period during which the employment services from which the stock option is derived are exercised (the "vesting period approach").

Notwithstanding the differences between the above and the CRA pre-2013 default position, the CRA has typically applied the principles in the OECD Commentary to resolve situations of double taxation under various tax treaties (with the exception of the U.S. Treaty) since 2005. The CRA default position, however, continued to apply in circumstances where no tax treaty was involved.

In September 2012, however, the CRA announced a shift in its position, stating that, for all stock options exercised after 2012, it will apply the principles set out in the OECD Commentary, except where a specific treaty otherwise provides or where the terms of the option agreement are such that the grant of the option is treated as a transfer of ownership of the securities (e.g., because the options were in-the-money or not subject to a substantial vesting period).[9] The latter proviso, which is

[6] See, for example, CRA *Document* 1999-0009047 (February 24, 2000) and CRA *Document* 2003-0037271I7 (February 6, 2004).

[7] Note that this position could be seen as contrary to the jurisprudence which suggests that employment income should be allocated to Canada using the most reasonable method, which may not necessarily be based on a time-based manner.

[8] See the Commentary accompanying the Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital: Condensed Version (Paris: OECD, July 2010) (the "OECD Commentary"), and the paragraph revisions made on July 15, 2005.

[9] CRA *Document* 2012-0459411C6 (September 25, 2012).

also seen in the OECD Commentary, appears to acknowledge the possibility that a stock option could be considered to relate to past services (i.e., services rendered prior to grant) where the option has value at the date of grant or is immediately exercisable.

It is to be noted that the U.S. Treaty does not follow either the grant period approach or the vesting period approach. Rather, pursuant to paragraph 6 of the diplomatic notes forming Annex B to the Fifth Protocol, the U.S. Treaty provides for an allocation formula based on days of principal place of employment during the entire option holding period.[10] As such, the stock option benefit is to be apportioned over each day between the date of an option grant and the date of option exercise.[11] In contrast with the OECD Commentary, the allocation formula under the U.S. Treaty does not take into account a vesting date of the option. The omission of this type of vesting concept would appear to permit, in theory, an executive to allocate more or less of the stock option benefit to one jurisdiction by continuing to hold a vested option and timing the date of exercise so as to give rise to the best tax result.

As a practical matter, some corporations take the position that stock option benefits should be allocated based on days worked during the vesting period (as suggested by the OECD Commentary) based on an interpretation of their particular stock option plan. Where this practice is justified by the facts and applied consistently, the CRA may accept it, notwithstanding the precise requirements of the U.S. Treaty.

Example

The different methods of allocation of stock option benefits, as between the CRA's pre-2013 approach, post-2012 approach, and under the U.S. Treaty is best illustrated by use of an example. Consider an executive who is resident in a foreign jurisdiction but who, on January 1, 2013, is granted a stock option with a two-year vesting period. In 2013, the executive exercises employment duties in Canada for 200 days, and employment duties in the foreign jurisdiction for 20 days. In each of 2014, 2015, and 2016, the executive exercises employment duties in Canada for 100 days and in the foreign jurisdiction for 100 days. The stock option vests on January 1, 2015 and the employee exercises the option on January 1, 2016. Under its pre-2013 approach, in the absence of the application of a tax treaty, the CRA would have sourced the executive's taxable stock option benefit in accordance with the days worked in Canada in the year of grant, being 200/220 or 90.9% taxable in Canada. Under the new post-2012 approach, the CRA will source the executive's taxable stock option benefit in accordance with the dates worked in Canada during 2013 and 2014 (the vesting period), being 300/420 or 71.4% taxable in Canada. If, however, the executive is a resident of the United States, the stock option benefit will be sourced in accordance with the dates worked in Canada during 2013, 2014, and 2015 (the entire holding period), being 400/620 or 64.5%.

Conclusion

The shift in the CRA position is a welcome one, in that it aligns the Canadian allocation method with that recommended by the OECD. To the extent, however, that the U.S. Treaty is at play, a different result may arise. Careful attention will need to be paid to these issues, particularly where stock options are exercised both pre- and post-2012.

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[10] For an example of the application of this formula by the CRA, see CRA *Document* 2012-0440741I7 (July 6, 2012).

[11] The diplomatic notes also permit the competent authorities of each of Canada and the United States to attribute the stock option benefit differently where they agree that "the terms of the option were such that the grant of the option will be appropriately treated as transfer of ownership of securities," giving the example of situations where the options are in-the-money or were not subject to a substantial vesting period. Consistent with the CRA position, this appears to acknowledge the possibility that a stock option could be considered to relate to past services. It would appear, however, that the per diem allocation approach must be followed unless and until the competent authorities otherwise agree. It remains to be seen when resort to the competent authorities will be necessary, and who is to initiate the process – i.e., the individual employee or one of the competent authorities.