Stock Options

By James A. Hutchinson (Miller Thomson LLP)

Included in the various tax measures set out in the Protocol are new rules that will clarify how stock options are taxed. Currently, there is ambiguity with respect to the sourcing of stock options in the situation where an employee who is granted a stock option while employed in one country (i.e., Canada) then works for the same or a related employer in the other country (i.e., the United States) before exercising or disposing of the option. Prior to the Protocol, there was no specific rule that provided for the apportionment of the stock option benefit between Canada and the United States.

The Protocol provides that for the purposes of applying Article XV (Income from Employment) and Article XXIV (Elimination of Double Taxation) of the Convention to income of an individual in connection with the exercise of an option that was granted to the individual as an employee of a corporation or mutual fund trust in respect of services rendered by such individual, the individual shall be deemed to have derived the same proportion of such income that the number of days in the period that begins on the day the option was granted and ends on the day the option was exercised or disposed of, in which the individual's principal place of employment for the employer was situated in that Contracting State is of the total number of days in the period on which the individual was employed by the employer.

In other words, the stock option benefits that is to be attributed to either Canada or the United States would be calculated as follows:

$$\frac{A}{B} \times C$$

Where A = the number of days in the period in which the individual's place of employment was in the respective Contracting State,

B = the number of days in the period that begins on the day the option was granted and ends on the earlier of:

(i) day the option was exercised or disposed of, or

(ii) the individual ceases employment with the employer, and

C = the amount of the stock option benefit calculated without reference to these rules.

The above rule is subject to the condition that if the competent authorities of both Canada and the United States agree that the terms of the option was such that the grant of the option will be appropriately treated as transfer of ownership of the securities (i.e., because the options were in the money or not subject to a substantial vesting period) then the competent authorities may agree to attribute income accordingly.

The example provided in the Notes to the Protocol is as follows:

"An employee of a United States company is granted a stock option on January 1, 2009. On January 1, 2010, the employee is moved from the company's US head office to its Canadian subsidiary. On December 31, 2011, the employee disposes of the option, giving rise to an income inclusion. Unless the Revenue authorities agree that the circumstances warrant the parting from the usual rule, one-third of the income will be treated as having a residence in the US and two-thirds in Canada".

The stock option changes introduced by the Protocol will assist in providing some certainty in the taxation of cross border stock option benefits.

James A. Hutchinson (jhutchinson@millerthomson.com) is a member of Miller Thomson LLP's Tax Group, in the Toronto office, at 416.597.4381.

