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TAXATION

Taxation of Stock Options

Stock options are beneficial to employees, allowing them to purchase shares in their employer corporation (or related company) below fair market value. Stock options can be a useful way to remunerate key employees when a company has a cash shortage (and the options would actually bring cash in when an employee exercises them), although this would also dilute the existing shareholders' ownership of the company. Employees granted company stock options are not taxed; however, employees who exercise the stock option and purchase the shares are considered to have received a benefit. How and when that benefit is taxed depends on who the employer is and whether the stock option price is below the fair market value of the shares at the time the option is granted.

Public company employers

If the option price is below the fair market value of the shares at the time the option was granted by a public company employer, the employee is deemed to have received a benefit that is included in their employment income when they exercise the option to purchase the shares. The amount of the benefit is equal to the difference between the fair market value of the shares at the date of purchase and the option price the employee paid. If the employee sells those shares at a future date, they would recognize a capital gain or loss equal to the difference between the sale price and the fair market value at the time the option was exercised.

For example, assume Pub Co. granted an option in 2017 to a key executive named Sarah to allow her to purchase 1,000 shares at $10 per share when the fair market value of the shares was $12. Sarah exercised those options in 2018 when the fair market value was $14 per share, and she sold them in 2019 for $15 per share. Sarah's fully taxable employment income in 2018 would be $4,000 [1000 shares × ($14-$10)]. She would also report a capital gain in 2019 of $1,000 [1000 shares × ($15-$14)], half of which is taxable.

Note that if Sarah had exercised the option in 2017 when it was granted, her employment income would have been $2,000 [1000 shares × ($12-$10)] in that year, and the 2019 capital gain would be $3,000 [1000 shares × ($15-$12)]. While the total income over the three-year period would be the same as in the first scenario, her total taxable income would decrease by $1,000, since a greater portion is a capital gain and only half of that is taxable.

If a public company employer grants stock options that do not have an immediate benefit to the employee (i.e., the option price is equal to, or greater than, the fair market value of the shares at the time the option is granted), the employee can deduct half the employment income benefit when the options are exercised as a "stock option deduction." This leaves half the benefit taxable in the year that the option is exercised – similar to the way that capital gains are taxed.

If Sarah's employer had set the option price at $12 (the fair market value of the shares at the time the option was granted) instead of $10, her 2018 employment income addition would have been $2,000 [1000 shares × ($14-$12)], but she would have been able to deduct $1,000 from her taxable income in that year as a stock option deduction.

Canadian-controlled private corporation (CCPC) employers

If the employer is a CCPC, the employment benefit is not taxable until the shares are sold, rather than when it is exercised. If the employee owns the shares for two years after the acquisition, half of the employment income addition can be deducted from taxable income as a stock option deduction. If the employee does not hold the share for two years, then they can claim the stock option deduction only if the option price is equal to, or greater than, the fair market value of the shares at the date the option was granted.

Note that although the effective tax rate for stock options that qualify for the stock option deduction is similar to that of capital gains, they are not considered capital gains (i.e., you cannot use them to offset any capital losses).

Federal budget changes for 2019

The original purpose for the preferential tax treatment of stock options was to assist the growth and development of small businesses (in the preliminary stages when cash flow may be limited) and compete with larger, higher paying companies to attract and retain talent. However, the government became increasingly concerned that stock options were often used to provide preferential tax treatment on the compensation paid to employees of large, mature companies.

The Budget proposed to cap the amount of stock options for which employees of "large, long-established, mature firms" could claim the stock option deduction at $200,000 per year. These changes are not intended to affect employees of CCPCs or "start-ups and rapidly growing Canadian companies." The $200,000 cap is determined for shares that become vested in a calendar year (generally the first year in which they can be exercised) and is based on the fair market value of the shares at the time the options are granted. The cap will be applied separately for employers that deal at arm's length.

Essentially, the Budget proposed that there be qualified options, which are subject to the current tax regime outlined above, as well as non-qualified options. While the employee is not entitled to the stock option deduction for non-qualified options, the employer can deduct the total option benefits recognized by the employee from the corporation's taxable income if certain conditions are met. In such cases, non-qualified options would be treated the same as any other employment income. At the time the options are granted, employers who are not CCPCs or "start-ups, emerging or scale-up companies" can take the options that meet the conditions to be qualified and designate them as non-qualified instead. These changes will not apply to stock options granted before 2020.

The characteristics of "start-ups, emerging or scale-up companies" will be defined by regulation following a stakeholder consultation period, which ended in mid-September 2019. Given the October election results, it is important that affected employees and employers continue to monitor and assess the potential impact of these changes.

DIGITAL MANAGEMENT

Do You Have a Spare Million? What You Need to Know About Canada's Anti-Spam Laws

Almost every business sends electronic messages. If yours is one of them, you must be familiar with Canada's anti-spam legislation (CASL). Though the legislation has been fully in effect since July 1, 2014, there remains a lot of confusion around it. CASL affects every type of business from private enterprises to not-for-profit groups and charities.

Who does CASL affect?

CASL's anti-spam provisions affect everyone who sends commercial electronic messages (CEMs) to, from or within Canada. A CEM is any electronic message that encourages participation in a commercial activity, regardless of any expectation of profit. The term is "tech-neutral;" in other words, it applies to emails, text messages, social media and other similar forms of communication. The general rule is, unless exempt under the legislation, a sender must have the consent (either express or implied) of the recipient before sending a CEM.

Why should you care?

There is a reputational risk if your business or not-for-profit group breaks the law, but CASL also allows for the imposition of rather significant fines. The maximum penalty for a breach by an individual is $1 million and for an organization is $10 million.

In addition to the potential risk posed to your business or not-for-profit group, the legislation also imposes what is called "vicarious liability". This means that not only is the organization that violates the law held accountable but so are its officers and directors, and employers are responsible for the actions of their employees. This means that any of these individuals may also be fined.

Does the general public care?

The Canadian Radio-television and Telecommunications Commission (CRTC) is responsible for the enforcement of CASL. Between April and September 2018, the CRTC received 137,000 complaints. That's more than 5,000 complaints each week, which represents a lot of very annoyed consumers.

While not every complaint will result in an investigation and the imposition of a fine, you don't want to be on the receiving end of either. Significant fines have already been imposed. The first instance occurred in 2014, when a Quebec business was fined $1.1 million for sending emails in violation of the legislation. Very few businesses can survive paying a penalty of that size.

Consent

As noted above, unless you fit within one of the exceptions set out in CASL, you must have the recipient's consent before sending a CEM.

There are two categories of exceptions:

- exceptions where neither consent nor mandatory content rules apply
- exceptions where mandatory content rules apply but consent is not required

You can't request consent if you don't have consent

Unless you fit within one of the exceptions, you must have the recipient's express or implied consent in order to send a CEM. It should be noted that a CEM asking for consent is still a CEM. In other words, you need consent in order to send such a request.

Express consent means that you expressly agree to receive CEMs. That consent can be oral but only if it is verified by a third party or recorded. Consent must not be bundled with terms and conditions. This means that, for example, it is insufficient to include the consent in the terms and conditions accepted to buy goods or use a service.

Further, opting-out isn't enough. People have to opt-in to receive CEMs. In other words, people must take an active step to signify their consent. This could include checking a box or typing in a word or email address.

Implied consent

Examples of implied consent include the following:

- existing business relationship if you either:
  - purchased services within the past two years
  - made an enquiry within the past six months
- existing non-business relationship if in the past two years, you either:
  - made a donation or gift to, or performed volunteer work for, a charity registered under the *Income Tax Act* or a political party
  - were a member in a "club," "association" or "voluntary organization"

It should be noted that clubs, associations and voluntary organizations are non-profit entities organized and operated exclusively for the social welfare, civic improvement, pleasure, or recreation or for any purpose other than personal profit if no part of their income is payable to any owner, member or shareholder.

Mandatory content of CEMs

Subject to certain exceptions, each CEM must contain the following information:

- the sender's name, telephone number and email / web address, as well as their affiliates and beneficiaries
- a physical mailing address, which remains accurate for at least 60 days after the message is sent
- an unsubscribe mechanism

The unsubscribe mechanism must be "readily performed." This means that it must be quickly accessible, simple and easy to use. It is very important to keep the communication distribution lists up to date. If someone has unsubscribed, you must remove them from your distribution list. Any opt-out or unsubscribe request must be honoured "without delay" and, at a maximum, no later than 10 business days after it is received.

Exceptions to consent and mandatory content rules

The exceptions to the requirements for mandatory content and consent are few and narrowly defined. A few such exceptions include the sending of CEMs:

- solely as an inquiry or application regarding recipient's existing commercial activities
- between employees, representatives, consultants or franchisees of an organization regarding the organization's activities
- to enforce a right
- by a charity that is registered under the *Income Tax Act* **and** has fund raising as its primary purpose

Exceptions where mandatory content does apply but consent is not required

You are exempt from the consent requirements but must comply with the mandatory content requirements if you are sending a CEM to:

- provide a requested quotation

- facilitate, complete or confirm a commercial transaction that the recipient previously agreed to enter
- provide warranty, recall or safety info about a purchase
- provide info about an existing employment relationship or related benefits

Conclusion

CASL is complicated legislation. This overview is intended to highlight the most important provisions in a simple way. It does not cover all the details. In order to ensure that you are in compliance with CASL, you must review the legislation and its regulations in their entirety and seek counsel.

MANAGEMENT

Disaster Recovery Planning: Steps to Protecting Your Organization

Disasters come in many shapes and sizes. Natural disasters are certainly cause for concern, but chances are that disruptions to your organization are more likely to involve application, communication or hardware failures. Properly planning for such unexpected events will not only help you respond effectively; it will also save you a significant amount of money.

What is a disaster recovery plan (DRP)?

The cost structure of potential downtime will dictate many of the specific components of the DRP and where emphasis needs to be placed. Typically, a reasonable DRP will include the following:

- formal documented sets of steps, lists and instructions needed to return to normal business operations
- instructions of a precautionary nature as well as prescribed reactions for recovery
- list of assets, key applications and data
- important details, such as locations and other relevant information
- contact information for all relevant personnel (both internal and external) and key third-party resources

The business cost of downtime

Understanding the cost incurred by the organization when systems go down is crucial to the concept of disaster recovery planning. Building an effective DRP will ultimately involve cost trade-offs, so it is imperative that one understands the dollar impact of specific system downtime and loss scenarios. These costs will vary greatly between businesses of different sizes, industry types and technological complexities. In a recent study, Gartner determined that costs exceeding US$5,600 per minute are possible. When determining these costs (beyond the traditional downtime costs), be sure to consider the following:

- payroll costs of idle employees
- overtime after recovery to get business back on track
- lost revenue that cannot be recouped
- lost customer trust

Preparing the DRP

The purpose of a detailed DRP is to bring consistency and predictability to unplanned shocks to the business system. The following is an outline of the steps required to develop your first DRP:

1. **Review the current environment –** The first step is to generate a comprehensive list of all IT equipment. Be sure to list all PCs, servers, network gear and storage solutions. Also include the location, configuration and device model details.
2. **Prioritize systems, applications and data –** Similar to the work above, document all applications, systems and data repositories present. These items need to be prioritized and the potential impacts of loss recorded. Be sure to record all applications in use (even the simple ones), enlisting the help of representatives from different departments. Having a comprehensive and prioritized list is essential.
3. **Conduct a risk assessment –** For each item in the above lists of assets and applications, review and document any risks associated with each. Consider everything from simple power outages through to full-scale natural disasters. Once your list is complete, add the perceived probability of each scenario along with its potential impact. With the complete picture of impacts and probabilities, you can determine the level of intervention required for each combination. This will also highlight the areas that are low impact and less probable. Obviously, less effort (and budget) can be directed toward those areas.
4. **Create a matrix for the recovery objectives –** This is where the real work comes in. Utilizing the work above, create a matrix outlining the recovery steps and procedures. As part of this effort, consider the amount of downtime that each component can realistically absorb. This is where you balance the need to minimize recovery costs against ensuring valuable assets and data are recovered effectively. In building the recovery steps, consider if there are any special tools or techniques required, and whether they are currently in place. This matrix will form the executional part of the plan if it ever needs to be put into action.
5. **Communicate the plan –** A DRP is not much use if all those involved are not aware of it. Ensure you have buy-in from all the necessary stakeholders so that unexpected barriers are not encountered upon the plan's execution. Distribute the plan widely but ensure that you record where it has been distributed so that any updates can also be accurately circulated.

After the plan is ready

A DRP is not a static document. If left unchecked, a DRP will quickly become dated and create a false sense of security. Plan deliberate practices of the recovery procedures to ensure proper understanding and effective execution by all stakeholders. Schedule regular reviews, and update the plan as needed. If gaps are present in the plan, work to fill them as your budget will allow. Your environment will change, sensitivity to downtime will evolve, and new technologies will be released – all of which will impact the accuracy and effectiveness of your plan. For that reason, a DRP requires constant re-evaluation and modification to help ensure its success.

WEALTH MANAGEMENT

A Primer on Probate

Probate is the court process to approve the validity of a deceased person's Will, and to appoint an executor for their estate who can then transfer assets to the beneficiaries. Probating a Will may not be required in all scenarios, such as when the first partner of a married couple dies or when there is no real estate or significant financial assets in the estate. However, probate is required when there is real estate not jointly held with a right of survivorship (i.e., it does not pass directly to the co-owner), or if a financial institution holding any of the deceased's funds or investments requires it.

Applying for probate

The executor will normally apply for probate in the province in which the deceased ordinarily lived. It may take many months to obtain a probate order in some jurisdictions, delaying the ultimate distribution of the estate to the beneficiaries.

The fees for obtaining probate, known as "Estate Administration Tax" in some jurisdictions, vary significantly between provinces. For example, the fees for a $2 million estate can range from a nominal fee in Quebec to have the Will authenticated by the Superior Court, to more than $30,000 in probate fees in Nova Scotia. In Ontario, probate fees are calculated at 0.5% on the first $50,000 of the estate and at 1.5% on the remainder, but no fees are payable for estates valued at less than $1,000. For estate certificates requested after December 31, 2019, Ontario has eliminated the Estate Administration Tax for all estates valued at less than $50,000, so the total probate fees will be 1.5% of the value of the estate in excess of $50,000.

Assets included in the estate

Probate fees are based on the fair market value of the assets in the estate at the date of a person's death. These assets include:

- real estate – net of encumbrances (e.g., mortgages and home equity lines of credit)
- bank accounts
- investments
- life insurance policies that list the estate as the beneficiary
- vehicles and vessels
- collections
- furniture

Probate will not apply to real estate jointly held with the right of survivorship, as the ownership is transferred directly to the co-owner. Similarly, life insurance policies as well as investments in Registered Retirement Savings Plans (RRSPs), Registered Retirement Income Funds (RRIFs) and Tax-Free Savings Accounts (TFSAs) that name a specific beneficiary are distributed directly to that beneficiary and therefore not included in the estate.

A probate order will only apply to the assets in the province in which the deceased ordinarily lived. If the deceased had assets in another province, the executor will have to apply to "reseal the probate," which requests that the courts in the second province confirm the Grant of Probate in the first province. For example, if the deceased normally lived in Ontario but also owned a ski chalet in Alberta, the executor would apply for the probate Certificate in Ontario to cover the home, investments and other assets there, and pay the appropriate probate fees to Ontario on those assets. Once the Ontario probate Certificate has been received, the executor would apply to reseal the probate in Alberta to cover the ski chalet and pay the appropriate probate fees on the value of it to Alberta.

It is worth noting that while mortgages are deducted from the value of the real estate, other debts such as car loans, credit cards or unsecured lines of credit are not deducted from the value of the estate. Similarly, there is no deduction for the potential selling costs for any assets in the estate.

Probate fee planning opportunities

Probate fees can be expensive, but there are some planning opportunities to minimize the costs. The first is to make sure that you name a beneficiary for all life insurance policies, RRSPs, RRIFs and TFSAs to ensure that these assets transfer directly to the beneficiary rather than be included in the estate. Caution should be used in how you do this, as there could be unforeseen consequences. For example, if you name one child as the beneficiary of your RRSP, that child would receive the total value of those assets. However, the RRSP is deemed to have collapsed on the death of the owner, and its fair market value is included in income in the final tax return of the deceased, unless the spousal rollover rules apply. Therefore, the estate would have to

pay the taxes on the value of the RRSP assets that only one child received, which may not be a fair result to all the beneficiaries.

A second planning opportunity that is sometimes mentioned is to add an adult child to the title of the home. This is often considered when the first parent of a married couple passes away. While this may reduce the probate fees on the death of the second parent, there may be some significant taxes and other issues to contend with, so extreme caution should be used in implementing this strategy. Adding the child to the title of the home is considered a "gift" for tax purposes, and there is a deemed disposition at its fair market value at the date of transfer. This would likely not trigger a taxable capital gain at that point, since the home would qualify as the principal residence for the parent. However, if that home was sold in the future and if the adult child has another residence, there could be a taxable capital gain on their share of the home for the difference between the fair market value at the date of transfer and the ultimate sale price. The value of the child's portion of the home could also be included in their assets if they became divorced or if a creditor sued them. Effectively, the parent has given the child control over half their home. This may also result in unequal treatment of the beneficiaries under the terms of the Will.

Another planning strategy includes using multiple Wills. The primary Will covers all assets that require probate in order to be transferred to the beneficiaries, which generally include bank accounts, investment portfolios and real estate. The secondary Will covers assets that can be transferred without requiring probate, including private company shares and personal effects, such as jewellery and artwork. When drafting these Wills, care should be taken to ensure that one does not have the effect of revoking the other, that each Will clearly identifies which assets it covers and that multiple Wills are recognized in the province of residence.

Finally, you can always consider giving assets to your future beneficiaries during your lifetime, as there is no gift tax imposed in Canada.

While probate fees may be a significant expense for an estate, it is important to obtain professional advice to ensure that you are not generating a steep income tax liability down the road or creating ill feelings between your beneficiaries that may last for generations.

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