US TAX ALERT

ARBUCKLE Personal Wealth Strategies

US TAX ALERT is a commentary on topics of current interest – usually topics relating to recent changes in tax law, new IRS administrative practices or current interpretations arising from tax cases. Professional advice should be obtained before acting on any of this information.

US CITIZENS OWNING CANADIAN STOCK OPTIONS

Generally, income taxes on public company employee stock options arise at the time the option is exercised (employment benefit) and then again at the time the stock is sold (capital gain or loss). The same is generally true both in Canada and the United States but there are some important technical differences that call for advanced tax planning. In Canada, the employment benefit can usually be deferred (in whole or in part) over several years, but not always so in the United States. If this happens, a mismatching of US and Canadian tax could result, increasing total taxes payable.

Tax Rate and Income Inclusion

Canada taxes all capital gains at the same rate whereas the US has both a short term (held for less than one year) and long term capital gain rate. Both countries tax the employment benefit at regular rates but Canada only taxes half of the benefit.

Tax rates (based on the top marginal rate bracket) are as follows:

	Canada	United States
Stock Option Benefit	23%	35%
Capital Gain		
Short term	23%	35%
Long term	23%	15%

The US tax rate shown above on long term capital gains is 15% which is less than the Canadian rate of 23% so US taxpayers should try to hold stock for at least a year after an option is exercised to minimize US taxes to below the Canadian rate.

In the end, the foreign tax credit mechanism effectively results in each source of income being taxed at the higher of the rates of the two countries. If stock is held for less than a year, the US rate of 35% on capital gains will prevail, moving taxes up by 12% over the 23% Canadian rate. If taxpayers can plan their dispositions to avoid US short term gains, the maximum rate (considering both jurisdictions) will be 23% rather than 35%. On the employment benefit side, the higher US 35% rate will always prevail.

Capital Loss Carry Back Planning

Canada allows capital losses to be carried back three years against capital gains of prior years but the US does not allow a carry back. US citizens living in Canada generally should not use the Canadian carry back to reduce Canadian taxes of prior years because that simply reduces the Canadian credit against US taxes and effectively increases US taxes payable by the same amount – a zero sum game. The existence of excess US foreign tax credits from previous years may change this and must be factored in.

Foreign Tax Credits

Each country gives a foreign tax credit for taxes paid to the country where the stock sale actually took place – but only to the amount of taxes payable of the country providing the credit. As mentioned above, in the end taxes paid will be based on the higher of the taxes in the two countries. Foreign tax credit calculations are extremely complex and will not be dealt with further.

US citizens living in Canada get a tax credit on their US return for Canadian taxes paid. In the case of the employment benefit, the Canadian tax at 23% can be fully offset in the United States against US taxes. Consequently, there is usually little point in deferring the employment benefit in Canada if it can't be done in the United States. Actually, if the employment benefit is deferred in Canada for more than one year (and not deferred in the US), no foreign tax carry back for US tax purposes to the year the option was taxed in the US is possible since tax credits can only be carried back one year in the United States.

General Planning Issues

In Canada, employment benefits and capital gains are both taxed at the same 23% rate. In the United States, the employment benefit and short term gain are taxed at 35% but the long term capital gain rate is only 15%. While there is no obvious bias for either type of income in Canada, there is definite bias in the United States for long term capital gains over both short term capital gains and the employment benefit.

If it is assumed that share prices generally increase over time, it would be best to minimize the option holding period and maximize the capital gain holding period. That would tend to minimize the option benefit and maximize the long term capital gain benefit. Obviously, specific facts will dictate.

In Canada, it is better to minimize the employment benefit and maximize the potential capital gain because should the gain could turn out to be a loss, the loss cannot be offset against the employment benefit.

Admittedly, these rules are confusing but the tax savings can be huge with proper planning. The trick is to start planning early and work with a good investment advisor as well as your tax advisor. Sometimes it's difficult for executives to realize that holding shares in a single company can be a dangerous thing and investment advice input is critical to full planning.

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