Thousands of Canadians taxed on 'phantom income'

Employees who lost on stock options face bankruptcy over huge tax bills

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By Kathy Tomlinson, CBC News

Shannon McLeod had to pay a $100,000 tax bill on 'phantom income' from worthless stock options. (CBC)

Thousands of Canadian workers who purchased stock options from their employers before the market downturn are expected to pay millions of dollars in taxes on income they haven't received because the shares have lost their value.

"I had to take out over a hundred thousand dollars in loans, plus interest, in order to pay off taxes," said marketing manager Shannon McLeod, a tech-industry worker in Vancouver who faced the same situation several years ago.

"I was a good little Canadian taxpayer and I paid it off, but it had a huge effect on me."

The income tax is applied to stock options, a benefit many Canadian employees are given as part of their remuneration. Employees at various levels of companies in high tech, mining, banking and other industries are allowed to buy stock in their firm at a significantly reduced price.

"Companies give out stock options to their employees thinking it is a huge benefit, and it's actually a huge liability," McLeod said.

Because of a little-known loophole in Canada's tax law, people are expected to pay income tax on the market value of the stocks when they are issued — not on their lesser value if they are later sold at a lower price. Those affected call it a tax on "phantom income."

Tax experts estimate many Canadians have been hit since the latest stock market downturn. The national group Canadians for Fair and Equitable Taxation says it's hearing about dozens of new cases from people who have just received their assessments for the 2008 tax year.

Taxpayers going bankrupt, losing homes

"I have colleagues at many different companies I've worked at since that have actually lost their homes," McLeod said. "They've gone bankrupt. It's a huge catastrophe — and it's something that the government can easily fix."


Tax lawyer William Cooper thinks Ottawa should allow people to claim their losses against the 'income.' (CBC)

For example, if an employee bought $100,000 worth of stock for the employee price tag of $25,000 early in 2008, they would be taxed on $75,000 worth of "income" for that year. If the employee held on to their stock, as many do, they would still have to pay tax on the $75,000 — even if the stock's value drops to mere pennies. Employees can defer remitting the tax until they sell the stock or the company is sold, but the tax bill doesn't change.

Thousands of tech-industry employees like McLeod have been hit since 2000.

McLeod bought 10,000 shares in Burnaby, B.C.-based digital-imaging company Creo — with money borrowed against the stock — for $17 each. At the time, the stock was trading at $53. She was assessed income tax on $360,000 — the difference between what she paid and the market value of the shares at that time. She was 27 years old and earning a modest salary of less than six figures.

"On the advice of my financial planner and my accountant, I held on to the shares. And then the market crashed," she said

Ottawa taxed McLeod $100,000 on the stock options, even though by the time the tax was assessed, the shares were worth less than she bought them for. Creo stock didn't recover and McLeod said she didn't make a penny. The company was eventually sold, and McLeod had to use a line of credit to pay the $100,000 bill.

"If I had again gone into the stock option plan with the company I am with now, right before the 2008 crash, I would again be in the exact same situation," McLeod said.

Thousands more potentially hit by downturn

"People just don't want to talk about it, and they certainly don't want to say I owe the government a quarter of a million dollars and I can't pay it," Vancouver tax lawyer William Cooper said.

"Right now there are probably thousands of people under water. And how many know about this tax before they get the bill? Not a lot. I would say very few."

Finance Minister Jim Flaherty indicated Ottawa has no plan to help affected taxpayers.

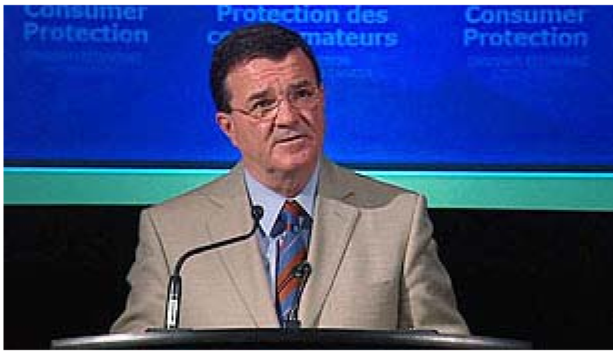
'I won't hold out any hope of any tax exemptions'

"The tax laws apply to all of us equally," Flaherty said. "There are some remedies that are available through hardship cases, but the reality is that those stock option situations are not uncommon and apply to a large number of Canadians. So, I can't and I won't hold out any hope of any tax exemptions in respect to that."

—Finance Minister Jim Flaherty

When Flaherty mentioned "hardship" cases, he was likely referring to JDS Uniphase employees from Victoria. After lobbying by their MP, Gary Lunn, 35 employees with the optical-equipment company were granted exemptions from paying the tax last year.

Nortel employees are another example, but they haven't received any exemptions. Many are still holding on to stock they bought at the employee rate years ago, when the market value was over $100 per share.



Federal Finance Minister Jim Flaherty says no exemptions will be granted. (CBC)

If Nortel's bankruptcy proceedings force the shares to be sold, their huge tax bills on those shares — worth approximately 25 cents each now — will come due. Former Nortel executive Ragui Kamel, an Ontario resident, said he has already paid $300,000 in taxes on stock he sold and could be hit with another bill soon.

"If Nortel collapses, through no action or desire of my own, I will be deemed to have sold the [remaining] shares I still hold in Nortel. That will trigger a tax of over $500,000 — wiping out the bulk of my savings in 30 years of work," Kamel said.

Former Nortel employee contemplates suicide

Another former Nortel manager from Toronto, who was let go in 1999, said he will get hit with a $204,000 tax bill on stock he still owns, which is worth $250.00 now. The man, who didn't want his name used, is 69 years old and said he has seriously contemplated suicide to avoid being forced to sell his house.

"I've been living a nightmare, not sleeping at nights. It's affecting my marriage," he said.

Tax lawyer Cooper said that, in his experience with tax policy makers in Ottawa, the effects of unfair rules are often not taken into consideration.

"Sometimes I think they are just in this bubble. All the technicians are saying, 'Well, this is how the rules work and this is how they are supposed to work and it all fits within the scheme of the Income Tax Act, so what is the problem?' "

"I think that the country needs to pull together and talk to their MPs and voice their opinion and let the government know that this isn't acceptable," McLeod said.

The United States had a similar tax policy until 2008, when the law was changed to essentially fix the problem for American employees who lost money through stock options.

"The fact that we are the only G7 country to do this still is kind of embarrassing. It's pretty archaic," McLeod added.

The tax treatment of any employee option granted in canada has the same tax liabilities as NQSO. Therefore they are the same IMO. The tax treatment for ISO in the USA is completely different. Read the link I provided. Educate yourself.

"The employee did exactly what the Joe Public did. It bought the options from the employers when he joined the company at which time the value of those option were at-the-money option, ie., intrinsic value equals $0, time value is subject to the risk of him loosing his employment and this valued at $0. (remember, the employee do not get access to his options at the time of grant, vesting period is typically 4 years) And he assumed exactly the same risk as Joe Public because if in 4 yrs the shares are lower then the grant/strike price, the options are worthless (exactly the same as those in the open market). His loss is the price he paid in terms of his lowered salary and his sweat. Even the current tax codes recognize that the gain (from sale or exercise of the options) is Capital Gain, and taxed like Capital Gain."

Show me how I can buy an at-the-money LEAP for 4 years in the future for zero dollars on the open market. The employee put up zero capital. Sweat doesn't count.

- *1*
- *2*

*1*Agree *2*DisagreePolicy Report abuse
Kahuna1957 **wrote:**Posted 2009/05/29
at 2:46 PM ET"If I buy shares on the open market and hold them through a period where I could have taken a profit but then the shares tank -- shouldn't I be taxed on the money I could have made? Just like the victims of employees who gambled on their employers shares via an ESPP/ESO Plan?" --vic

Not at all. You risked your own capital (after tax dollars) to buy the stock. Any gain is a capital gain, any loss a capital loss. They risked no capital. If they held shares past when they received them, the risk is all theirs. They haven't paid the tax on their gains as you have already done with your after tax dollars.

- *0*
- *2*

*0*Agree *2*DisagreePolicy Report abuse
Chris2701 **wrote:**Posted 2009/05/29
at 2:45 PM ET"Just because you chose to hang on to the shares and they lost there value doesn't change that you originally received a $40/share benefit from the company and need to pay tax on it."

That is not accurate. Yes, the company chipped-in $40 to help purchase the share, but the money is in the share, the employee has not received that money. If the share drops in value then the money in the share disappears with it, hence the phantom income the employee never received but which the government still expects taxes to be paid on.

One could use the perspective that the stocks received the benefit (not the employee) and therefore the stocks should be charged the tax, which is what the ability to defer the tax until the stocks are sold accomplishes.

The problem left with this situation is that, depending on what happens when a company goes bankrupt, the employee who owns the said stock has no control over the sale! To me this seems like someone selling my house without my consent, keeping all the profits, and then I still have to finish paying the mortgage.

- *3*
- *0*

*3*Agree *0*DisagreePolicy Report abuse
mikep00 **wrote:**Posted 2009/05/29
at 2:27 PM ETThere is not "phanton income" as CBC claims.

They received a taxable benefit (option to buy the shares at below market value) and rightfully need to pay tax on it. For example, Share A is trading at $100/share, with the stock option the company gave the employee they can buy that $100 share for say $60. Basically they paid $60 and the company chipped in the other $40. So why should they not pay tax on that $40 the company "gave" them.

Just because you chose to hang on to the shares and they lost there value doesn't change that you originally received a $40/share benefit from the company and need to pay tax on it.

The Income Tax Act tried to be nice by giving you the option to defer the tax until after you sold the stock (so you didn't have to come up with the tax upfront). So you chose to defer the tax liability and now lost all the money on the stock market, how does that change the tax liability on the benefit you received in the first place. You still received that benefit regardless.

I laugh at people who want us to feel sorry for them because they lost the money they received. You chose to hold the stocks, you chose to defer the tax, it is nobody's fault you can't afford the taxes now except your own.

- *3*
- *5*

*3*Agree *5*DisagreePolicy Report abuse

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