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BUDGET 2019: GOVERNMENT SEESAWING ON TAXATION OF STOCK OPTIONS

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Budget 2019 announced the Government's intention to introduce an annual cap of $200,000 on employee stock option grants that may be eligible for tax-preferred treatment for employees of, what the Department of Finance ("**Finance**") refers to as, "large, long-established, mature companies". The proposed stock option changes would not affect "start-ups and rapidly growing Canadian businesses".

Budget 2019 did not include proposed legislation, thereby leaving out many of the details regarding the manner in which the current regime will be altered. However, Finance indicated that any changes would apply on a prospective basis only and would not apply to employee stock options granted prior to the announcement of legislative proposals.

Current Regime

Under the current regime, three points in time are relevant to the taxation of stock options under the *Income Tax Act* (Canada) (the "**Tax Act**"): the grant date, the exercise date and the date of disposition. Grants of qualifying stock options to an employee, which are usually subject to vesting conditions, are non-taxable events. Once the options vest, the employee is able to exercise the options to receive shares in the issuing company at a pre-determined price (usually the fair market value of such shares at the time of grant). When the stock options are exercised, a taxable benefit from employment is included in the individual optionholder's income equal to the difference between the fair market value of the shares on the date the options are exercised and the option exercise price. The employee may then retain the shares acquired or dispose of them at will. When such shares are disposed of, the employee is taxed on the gains (if any) that may arise from the sale of such shares. In the case of options issued by a Canadian-controlled private corporation (a "**CCPC**"), the taxable event arises on the date of disposition and not on the date of exercise.

Provided certain prescribed criteria are met, an employee exercising stock options is generally able to claim a deduction equal to one-half of the employment benefit that arises when the stock options are exercised (or disposed of, in the case of a CCPC). This is referred to as the "Stock Option Deduction". For example, suppose an employee is granted stock options to acquire 100,000 shares of his corporate employer at their fair market

value of $50 per share. A few years later, the employee exercises the stock options when their fair market value is $70 per share. The employee will recognize an employment benefit of $2 million (100,000 x ($70 - $50)) and would generally be entitled to claim a Stock Option Deduction equal to one-half of $2 million when computing his/her taxable income. This effectively provides preferential capital gains-like tax treatment on an amount that is otherwise employment income to the employee.

It is important to note that issuing employers are not entitled to a deduction when computing income in respect of shares issued on the exercise of stock options. In addition, where stock options are cashed-out, only one of the employer or the employee, but not both, is entitled to claim a deduction in respect of the cash-out amount.

Background

In its 2015 election platform, the Government expressed an intention to set a cap on the amount that may be claimed through the existing Stock Option Deduction mechanism. At that time, Finance noted that "8,000 very high-income Canadians deduct an average of $400,000 from their taxable income via stock options". This represented three quarters of the $750 million total fiscal impact of the Stock Option Deduction in 2014. The Government's platform suggested that employees with up to $100,000 in annual stock option gains would be unaffected by any proposed caps.

After concerns were voiced, mostly by technology and natural resource start-ups, Finance stepped away from the proposal. As the 2019 federal election nears, stock options are now up for renewed discussion.

Proposed Changes

Budget 2019 proposes to limit the Stock Option Deduction so that it is available only in respect of employee stock option grants of up to $200,000 (based on the fair market value of the underlying shares) on an annual basis. An example best illustrates the Government's new proposal.

Suppose that an employee is granted stock options to acquire 100,000 shares of her/his large, long-establish, mature employer at their fair market value of $50 per share. This represents an option grant of $5 million (100,000 x $50). Only $200,000 of this $5 million will be eligible for the preferential tax treatment under the new Budget proposals. In other words, when exercised, the employment benefit associated with only 4,000 of the options ($200,000 / $50) will be eligible for the Stock Option Deduction. If the employee exercises the stock options when their fair market value is $70 per share. The employee will generally recognize a total employment benefit of $1.96 million consisting of the full employment benefit in respect of 96,000 shares (96,000 x ($70 - $50)) and one-half of the employment benefit in respect of 4,000 shares (4,000 x ($70 - $50)).

Under the proposed measures, the total income inclusion for the employee will be equal to $1.96 million

compared to the $1 million under the current regime. It is important to note that stock option benefits that are not eligible for the Stock Option Deduction will now be deductible for corporate income tax purposes based on the example provided in Budget 2019. The proposals will apply only in respect of large, long-established, mature companies and will not apply to start-ups and emerging Canadian businesses.

The Cases For and Against Preferential Tax Treatment of Stock Options

Businesses use employee stock options to align the employees' interests with those of the business and to increase employment engagement and promote entrepreneurship and growth. The underlying rationale for stock option grants is that employees will be more vested in a company where their remuneration is linked to the future success of the company.

Others argue that stock option compensation is not good for companies and may promote risk-prone management styles. They cite data that shows a lack of correlation between stock option issuances and enhanced returns for the company.

The Budget Plan indicates that the Government was guided by two key objectives in introducing the proposed changes:

- to make the employee stock option tax regime fairer and more equitable for Canadians, and
- to ensure that start-ups and emerging Canadian businesses that are creating jobs can continue to grow and expand.

According to data published in the Budget, in 2017, 2,330 individuals claimed Stock Option Deductions amounting to over $1.3 billion. These individuals represented 6 per cent of the total number of claimants of the Stock Option Deduction, but their total deductions amounted to almost two-thirds of the approximately $2 billion deducted. (The data cited in the Budget does not provide a breakdown of the number of employees, out of the 2,330 individual Stock Option Deduction claimants, who were employed by large, long-established, mature companies.) The purpose of the proposals, the Budget Plan provides, is to address this “inequity” that disproportionately accrues to a very small number of high-income individuals as well as align the tax treatment of employee stock options with that of the United States.[1]

It is not clear whether the data provided accounts for the fact that 2017 was a particular busy year in terms of M&A activity and that the technology sector continued to be Canada's most active industry sector in 2017, with a 34% increase in deal volume over 2016.[2] It is an open question whether the data cited in the Budget is consistent with long-term market trends.

There are a number of arguments in support for the preferential tax treatment of stock options under the current regime. In almost all cases, compensation in the form of stock options is not immediately at the

disposal of the employee because they remain subject to vesting conditions. Capital gains treatment compensates for the delay (and therefore, the time value of money) in receiving shares that are the subject of such options. In addition, the fact that stock options are a distribution of shares and not cash, absent an immediate disposition of such shares after exercise, the employee must front the requisite amount of cash not only to exercise the options, but also to satisfy the ensuing tax liability. Finally, stock options are a component of an employee's total compensation, such that the employer would have to provide greater cash outlays in the absence of stock option grants. Such cash outlays would be deductible by the employer immediately and result in an increased tax expenditure by the Government. Budget 2019 contemplates that companies will be permitted to deduct amounts in respect of stock granted under options that are not entitled to preferential tax treatment. The amount of this projected corporate tax expenditure by the Government is unclear.

The Budget enunciates supporting younger and growing Canadian business as the public policy rationale for preferential tax treatment of employee stock options. The Government does not believe that stock options should be used as a tax-preferred method of compensation for executives of large, long-established, mature companies. The tax policy rationale underlying the proposed changes in respect of younger and growing Canadian businesses is certainly defensible. In cash strapped start-ups that cannot pay their employees large salaries, stock options form a key component of attracting and retaining talented employees. However, the basis for treating employees of "large, long-established, mature" companies differently is less understandable. Are such companies less innovative? Should the tax system not motivate innovation at large organizations that possess the capital to fund research and innovation? Do employees of large, long-established, mature companies feel less attracted by the future upside in owning shares of their employer?

Implications

Budget 2019 indicated that legislative proposals would follow in the summer of 2019 to define the parameters of the stock option proposals. In the absence of draft legislation, a number of questions remain unanswered:

- How will "large, long-established, mature companies" be distinguished from start-up companies (e.g., capital assets, employees, revenue, years in existence)?
- What will be the timing and mechanics governing the deduction, for corporate income tax purposes, in respect of stock option benefits in excess of $200,000 per year?
- Will there be aggregation or carryforward/carryback rules to equalize caps over time?
- How will CCPCs be affected by the proposals?
- Would resident and non-resident companies be treated differently?

The proposed legislation may see employers reducing vesting times to increase the number of years over which the deduction may be claimed. Employers may also consider limiting stock option grants to the extent

that the Stock Option Deduction will be available to their employees. There may be increased litigation from companies trying to fit within the start-up category in order to be exempt from the proposed rules. Alternatively, “large, long established, mature companies” may also consider creating arm’s length employee shareholder entities to fit within the start-up category.

As a practical matter, payroll departments will also need to implement additional procedures to ensure that source withholdings are accurately calculated.

It is noteworthy that Finance has not provided the fiscal impact of limiting the Stock Option Deduction. Based on the examples provided in the Budget, where the $200,000 grant cap in respect of stock options is reached, the issuing company will be entitled to a deduction in respect of the excess over $200,000. This effectively shifts the deduction to the company, which would have been previously available to the employee. Ultimately, enactment of the new proposals may not generate any additional tax revenue for the Government.

by Ehsan Wahidie

[1] Under the *Internal Revenue Code*, there are two types of stock options: “incentive stock options” (ISOs) and “non-qualified stock options” (NQSOs). The employer receives a deduction in respect of NQSOs, but not ISOs. NQSOs are fully taxable to the employee, whereas ISOs receive preferential tax treatment, as long-term capital gains, provided certain holding period criteria are met. Qualification for ISO treatment is also restricted based on an annual monetary cap in respect of the shares.[ps2id id='1' target=''/]
[2] PwC Canada Deals Report, 2017.[ps2id id='2' target=''/]

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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