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IMPLEMENTING A CAP ON EMPLOYEE STOCK OPTION DEDUCTIONS

Posted on July 16, 2020

Categories: Insights, Publications

In Budget 2019, the Government announced its intention to propose legislation that would introduce an annual cap on certain employee stock option grants that may be eligible for certain tax-preferred treatment. On June 17, 2019, the Department of Finance ("**Finance**") tabled draft legislation (the "**Proposed Legislation**") to amend the *Income Tax Act* (Canada) (the "**Tax Act**") to advance the Government's proposal.[1]

As described in greater detail below, the Proposed Legislation would implement the announcement from Budget 2019 to introduce a $200,000 annual cap on stock option grants that may be eligible for certain tax-preferred treatment (the "**Cap**"). Canadian-controlled private corporations ("**CCPCs**") are exempt from the Cap. Non-CCPCs that meet certain prescribed conditions ("**Prescribed Employers**"), intended to capture "start-ups, emerging, or scale-up companies", are also exempt from the Cap. The Government is consulting with the public on what the prescribed conditions should be for this purpose.

The Cap will not apply in respect of options granted before January 1, 2020. It should be noted that the Canadian federal election scheduled for October 21, 2019 creates some uncertainty regarding whether or not the Proposed Legislation will be enacted into law.

The Current Rules

Under the current regime, 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 typically entitled 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, less any amount paid by the employee for the option. Provided certain legislative and prescribed criteria are met (including a requirement that the exercise price of the option, plus any amount paid to acquire the option, is not less than the fair market value of the subject shares on the date of grant), an arm's length employee exercising employee stock options is generally able to claim a tax deduction equal to one-half of the taxable employment benefit that

arises when the stock options are exercised (or disposed of, in the case of a CCPC, as described below) (the "**Stock Option Deduction**").[2] This effectively provides preferential capital gains-like tax treatment on an amount that is otherwise taxable as employment income to the employee.

The employee is taxed on the gains (if any) that may arise from the sale of such shares on their disposition. In the case of options issued by a CCPC, the taxable employment benefit is generally included in the employee's income in the year of disposition and not on the date of exercise.

Issuing employers are generally not entitled to a deduction when computing income in respect of shares issued on the exercise of employee stock options. Where stock options are purchased by an employer for cancellation (a so-called "cash-out" transaction), an optionholder is generally only eligible for the Stock Option Deduction if the option would otherwise be entitled to a Stock Option Deduction if exercised and his or her employer makes a valid election under subsection 110(1.1) of the Tax Act agreeing to forego any deduction that may have otherwise been available in respect of the cash-out payment.

The Proposed Rules

Generally. The Proposed Legislation limits the Stock Option Deduction so that it is available only in respect of employee stock options of up to $200,000 that may vest in a year, based on the fair market value of the underlying shares on the date such options are granted.

Scope. The Proposed Legislation applies only in respect of shares in the capital of corporations and units of mutual fund trusts. CCPCs and Prescribed Employers are exempt from the Cap. The Cap will not apply in respect of options granted before January 1, 2020.

Employee Treatment

The Cap applies on an employer by employer basis, such that an individual with multiple employers would have a separate Cap for each employer who deals at arm's length with the other employers.

The Cap applies to the amount of the employee stock options that may vest to an employee in a year, a determination made at the time the options are granted. This is achieved by the introduction of a defined "vesting year" concept in section 110 of the Tax Act. The vesting year of a security to be acquired under an employee stock option agreement refers to the year in which the employee's right to acquire the security first becomes exercisable (otherwise than as a consequence of a reasonably unforeseeable event), if such year is indicated in the agreement. Otherwise, the vesting year is the first calendar year in which the right to acquire the security can reasonably be expected to be exercised. We note that the concept of "vesting year" takes a rather simplistic view of the variety of arrangements that are possible in respect of stock options (e.g., performance based vesting conditions). There is bound to be uncertainty under certain option plans regarding

the vesting year of options. Employers and employees would be well served by clearly identifying the vesting schedule or terms in any such agreement.

Where the employee stock option exceeds $200,000 in any given year, the first options to be granted will qualify for the Stock Option Deduction, up to $200,000. The Stock Option Deduction will not be available in respect of any remaining stock option benefit, which will be included in the employee's employment income for the year without the benefit of the Stock Option Deduction (i.e., to be taxed at the employee's personal marginal tax rate).

Employer Treatment

The Proposed Legislation adds paragraph 110(1)(e) to the Tax Act to permit an employer to claim a deduction for income tax purposes to the extent that an employee is not entitled to the Stock Option Deduction (i.e., in respect of grants in excess of the Cap). The deduction is permitted if the issuing entity is a corporation (other than a CCPC or a Prescribed Employer), the issuing entity is the individual's employer, the Stock Option Deduction would have been available if the Cap did not apply, and the notifications requirements, discussed below, are fulfilled. If available, the deduction would be claimed in the year in which the subject options are exercised.

Under the Proposed Legislation, the issuing employer is required to (i) notify the employee in writing whether or not the stock options are subject to the Cap, and (ii) notify the CRA in prescribed form filed with the issuing employer's tax return that the options are subject to the Cap.

Finally, the Proposed Legislation permits an employer other than a CCPC or a Prescribed Employer to designate employee stock options as ineligible for the Stock Option Deduction and instead claim a deduction for corporate income tax purposes, a designation currently available only in respect of certain option cash-out payments.

Example

The following example drawn from the Backgrounder to the Proposed Legislation is instructive:

In February 2020, an employee of a corporation is granted employee stock options to acquire 40,000 shares at their fair market value of $4 per share. The options vest in 2022. In July 2020, the employee is granted an additional 30,000 options with the same strike price ($4) and vesting date (2022). All of the 40,000 employee stock options granted in February will continue to qualify for the Stock Option Deduction because the total grant does not exceed $200,000 ($4 × 40,000 = $160,000). However, only 10,000 of the options granted in July 2020 will qualify for the Stock Option Deduction ($4 × 10,000 = $40,000 = $200,000 - $160,000). The benefit on the remaining 20,000 employee stock options will be fully taxable to the employee.

If the employee exercises 50,000 options in 2022, all of these options will be considered to qualify for the Stock Option Deduction. If the price of the share has increased to $6, the stock option benefit of $100,000 (($6 - $4) × 50,000) will receive preferential personal income tax treatment (with no deduction to the employer). However, if the employee exercises any additional options later in 2022, all of the stock option benefit on those options will be included in her income and fully taxed at ordinary rates (with a deduction to the employer).

Purported Policy Rationale

In the 2015 federal election, the Government campaigned on the promise "to target tax loopholes that particularly benefit Canada's top one per cent."[3] Specifically, it pledged to close the perceived stock options loophole under the Tax Act by capping the Stock Option Deduction at $100,000 in annual gains. The stated purpose of the 2015 initiative was to limit the amount of the Stock Option Deduction available to high level executives. The Department of Finance more recently indicated that 6% of the Stock Option Deduction claimants, each earning in excess of a million dollars in 2017, claimed approximately 64% of tax expenditure in respect of employee stock options in that year.[4] Although the 2015 election promises were abandoned in 2016, Budget 2019 and the Proposed Legislation have resurrected a modified version of the election promise.

The Backgrounder to the Proposed Legislation identified two key objectives regarding the stock option proposals from Budget 2019: 1) to ensure that start-ups and emerging Canadian businesses that are creating jobs can continue to grow and expand, and 2) make the employee stock option regime fairer and more equitable for Canadians.

The Proposed Legislation Misses the Mark

Unfortunately, the Proposed Legislation will make it more difficult for Canadian employers to attract and retain employees and add to the compliance burden of employers while only partially addressing the stated objectives of the Government. Canadian companies need to compete in the global marketplace for top-performing employees. Many competitor jurisdictions provide employees with preferential tax treatment for employee stock options or other employee compensation plans. The practical effect of the Proposed Legislation may be that Canadian companies are now required to pay more to attract and retain employees while being burdened with additional compliance obligations, thereby harming Canadian competitiveness. The regime also risks introducing arbitrary distinctions between the tax treatment of employee compensation among competitors in the Canadian marketplace, potentially discouraging foreign capital to invest in Canadian businesses and employ Canadian workers.

Importantly, the Proposed Legislation maintains the Stock Option Deduction in its current form in respect of CCPCs and Prescribed Employers by exempting them from the Cap. This exemption from the Cap should mitigate some of the harmful effects of the Proposed Legislation. Interestingly, neither Budget 2019 nor the

Backgrounder to the Proposed Legislation provides a breakdown of the number of employees, out of the 2,330 high-earning individual Stock Option Deduction claimants, who were employed by CCPCs and Prescribed Employers versus those by "large, long-established, mature companies." If these individuals were employed by CCPCs, startups or emerging and scale-up companies, then the Proposed Legislation may not completely address a material portion of the high-income employees earning the deduction.

The Proposed Legislation proposes to grant certain employers a tax deduction in respect of amounts in excess of the Cap. As such, the Proposed Legislation will see a conversion of a favorable tax treatment from employees' personal taxes to a corporate deduction. The perceived value of stock options in employee compensation plans is likely to diminish after January 1, 2020. Therefore, large, mature companies will likely have to revisit their stock option and other employee compensation plans to ensure employees are receiving the appropriate form of remuneration.

The Department of Finance will be accepting submissions in respect of the criteria to be applied to identify Prescribed Employers until September 16, 2019. If you would like further information regarding the process, or assistance in making a submission, please contact the McMillan Tax Team.

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[1] The existing regime and Proposed Legislation apply in respect of "securities", which the Tax Act defines for this purpose as being shares in the capital stock of corporations and units of mutual fund trusts. Unless otherwise specified, all references in this bulletin to stock options, corporations and shares/stock should be understood to also include reference to options in respect of mutual fund trust units, mutual fund trusts and mutual fund trust units, respectively.
[2] The Tax Act also provides an analogous one-half deduction in respect of certain shares in the capital of CCPCs acquired by employees pursuant to stock options that are ineligible for the Stock Option Deduction if such shares are held by the subject employees for more than two years from the date of exercise. The Proposed Legislation does not affect such deductions.
[3] The Liberal Fiscal Plan and Costing, "Growth for the Middle Class" (2015), online: The Liberal fiscal plan and costing.pdf.
[4] Canada, Department of Finance, Backgrounder: Proposed Changes to the Tax Treatment of Employee Stock Options, (17 June 2019).

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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