CAPITAL GAINS CONFUSION: NAVIGATING THE OPTIONS FOR REPORTING EMPLOYEE STOCK OPTION BENEFITS

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Update: On January 31, 2025, the Department of Finance announced that the federal government is deferring the date on which the proposed increase to the capital gains inclusion rate, and the corresponding changes to the deduction that may be claimed in respect of stock option benefits, will take effect. The government has announced that the proposed changes will not take effect until January 1, 2026. As a result, the commentary below should no longer apply in respect of stock option benefits realized in 2024 or 2025.

Proposed amendments to the *Income Tax Act* (Canada) (the "**Tax Act**") contemplate an increase in the portion of a capital gain required to be included in the income of a taxpayer.

Corresponding amendments have been proposed that will effectively require an increased portion of the taxable benefit received by an employee that exercises an employee stock option to be included in the employee's taxable income (the "**Stock Option Change**").

The Stock Option Change will increase certain source withholding and remittance obligations for employers when their employees exercise qualifying stock options.

The prorogation of Parliament earlier this month and the increasing likelihood of a spring election have cast doubt on the prospects of the Stock Option Change being enacted into law. Unfortunately, the Canada Revenue Agency (the "**CRA**") has indicated that it nevertheless intends to administer the Tax Act as if the Stock Option Change has already been enacted, creating a difficult dilemma for employers.

Background

In the 2024 Federal Budget ("**Budget 2024**"), the Government announced its intention to increase the capital gains inclusion rate in respect of capital gains arising on or after June 25, 2024 (the "**Capital Gains Changes**"). Capital gains realized by an individual (other than a trust) after June 25, 2024 (generally in excess of a $250,000 annual limit) will be included in the computation of the individual's taxable income at an increased rate of 66.7% (up from 50%).

To preserve the largely symmetrical tax treatment of capital gains and benefits arising on the exercise of

employee stock options, Budget 2024 also proposed changes to the deduction that may be claimed by employees that realize a taxable benefit on the exercise of employee stock options (the "**Deduction Changes**"). Upon enactment of the Deduction Changes, 66.7% of employee stock option benefits in excess of $250,000 received by a taxpayer in a year will effectively be included in the individual's income.

The proposed Deductions Changes were included in a Notice of Ways and Means Motion brought before Parliament on September 23, 2024 (the "**September NWMM**"). However, the recent prorogation of Parliament has made it unclear whether the Deduction Changes will be enacted into law.

Despite this uncertainty, the CRA has taken the position that, because the Government included the Deduction Changes in the September NWMM and has not publicly resiled from that position, the CRA must administer the Tax Act as if the Deduction Changes will be enacted into law with retroactive effect. (See McMillan's bulletin from January 10, 2025 for more insight into the basis for the CRA's choice to administer certain legislative changes proposed in Budget 2024 before they are enacted.)

The Taxation of Employee Stock Options: A Primer

How Employee Stock Option Benefits are Taxed

When employees exercise stock options granted by their employer, they are generally considered to have received a taxable benefit from employment, which is commonly referred to as a stock option benefit. The amount of the benefit is equal to the amount by which the fair market value of the subject shares on the exercise date of the option exceeds the sum of the exercise price of the option (i.e., the price paid by the employee to acquire the shares that are the subject of the option) and the amount paid by the employee to acquire the option, if any.[1]

Employer Withholding Requirements

Stock option benefits are treated as remuneration for the purposes of the source deduction rules in the Tax Act. In the case of stock option benefits, employers are required to withhold income tax and Canada Pension Plan ("**CPP**") contributions, unless the employee is cashing out the employee's options—i.e., receiving the cash value of their stock option benefit—in which case employers must also withhold Employment Insurance ("**EI**") premiums.[2]

However, employers are generally permitted to reduce the amount of required income tax source withholdings in respect of stock option benefits by an amount equal to the stock option deduction the employee may claim under paragraph 110(1)(d) of the Tax Act (the "**Stock Option Deduction**").

The Stock Option Deduction

Under the current provisions of the Tax Act, provided a stock option satisfies certain conditions, employees are permitted to claim the Stock Option Deduction, which is equal to 50% of their stock option benefits. The Stock Option Deduction is designed to ensure that stock option benefits are ultimately subject to tax in a manner that parallels the taxation of capital gains. To maintain the symmetrical tax treatment of capital gains and employee stock option benefits, the Deduction Changes propose to reduce the deduction allowed under paragraph 110(1)(d) of the Tax Act from one-half to one-third of the stock option benefit. The Deduction Changes also introduce a new provision to the Tax Act—paragraph 110(1)(d.4)—which provides an "additional deduction" (the "**Additional Deduction**"). In effect, the Additional Deduction permits employees to retain the 50% deduction from employee stock option benefits on the first $250,000 of cumulative stock option benefits they earn in a year.

Example

Consider the following example of an employee who, on July 1, 2024, exercises her stock options and receives an employee stock option benefit of $500,000.

Under the current provisions of the Tax Act, the employee would include $500,000 in her income and then claim the 50% Stock Option Deduction, leaving $250,000 of taxable income. By contrast, under the proposed Deduction Changes, the employee would claim (i) the reduced 1/3 deduction in respect of the $500,000 stock option benefit, (i.e., $166, 667), and (ii) the Additional Deduction equal to 1/6 of the first $250,000 of the stock option benefit (i.e., $41,667), resulting in a total deduction of $208,334 and a net income inclusion of $291,666.

The Deduction Change and its Impact on Employers

Employers whose employees receive a stock option benefit now face difficult tax withholding decisions. Under the proposed Deduction Changes, employers are required to withhold income tax on two thirds—as opposed to one-half—of the taxable benefits arising from the exercise of employee stock options.

Although employees may be entitled to claim the Additional Deduction, employers are not entitled to reduce required withholdings by the amount of the Additional Deduction.

Consequences for Failing to Correctly Make Source Deductions in Respect of Stock Option Benefits

Employers who fail to withhold and remit the correct amounts in respect of employee stock option benefits may be liable to penalties and interest, and, in some circumstances, the amounts not withheld or remitted.

Employers who fail to make required source withholdings may be liable to a penalty equal to 10% of the amount of income tax, CPP contributions, and, where applicable, EI premiums, they failed to withhold. Similarly, the employer may also be liable for interest on amounts not withheld.

With respect to payments to non-resident employees, or employees deemed to be resident in Canada by paragraph 250(1)(a) of the Tax Act, employers who fail to make required source withholdings are also liable to pay the amount of income tax that should have been withheld.

Finally, where a corporation fails to withhold or remit required source deductions in respect of employee stock option benefits, the directors of the corporation may become jointly and severally, or solidarily, liable, together with the corporation, to pay those amounts and any associated penalties or interest related to such amounts.

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Employers who have offered stock options to employees find themselves in a particularly uncertain position: they must adopt a withholding practice that is based on either (i) an administrative position of the CRA that is not consistent with the law as it currently stands, or (ii) the law, as currently enacted, which is not consistent with the administrative position being taken by the CRA.

It is hoped that the CRA will grant employers and employees alike relief from interest and penalties if they must take action to correct past reportings and remittances when the status of the Deduction Changes is resolved. Unfortunately, no comfort has been provided by the CRA in this regard to date.

[1] Where the shares that are the subject of an employee stock option are shares of a "Canadian-controlled private corporation" (a "**CCPC**"), provided that certain requirements in the Tax Act are satisfied, (i) the required income inclusion is generally deferred until the year in which the employee disposes of the shares, and (ii) the employer is typically relieved of source withholding and remittance obligations.
[2] As noted above, there are no CPP or income tax withholding requirements when an arm's length employee disposes of the employee's shares in a CCPC that were acquired on the exercise of employee stock options; see here.

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A Cautionary Note