SIGNIFICANT TAX CHANGES ON THE HORIZON

Posted on November 20, 2015

Categories: Insights, Publications

On November 4, 2015, the leader of the Liberal Party of Canada, Justin Trudeau, was officially sworn in as Canada's 23rd Prime Minister. Mr. Trudeau replaces the Conservative Party's Stephen Harper, who had served as the Prime Minister of Canada since February of 2006.

Over the course of the lengthy campaign that culminated in the election of the new Government, the Liberal Party made a host of campaign promises that could fundamentally alter the Canadian tax system.

While the new Government's campaign pledges have yet to be enacted into law, much speculation has focused on when certain of the proposed tax changes might take effect. If past governmental practice is any indication, the anticipated tax changes may apply from the day that a formal announcement is made by the Minister of Finance, even if the required enabling legislation is not enacted until a later date. Many have also speculated that a Notice of Ways and Means Motion, containing a host of tax-related amendments, could be introduced once Parliament is recalled on December 3, 2015. In short, it is possible that many of the campaign promises made by the new Government may come into force in the very near future.

Business Tax Changes

The Liberal Party proposed a number of business-related tax changes as part of its election platform.

(i) Changes to the Taxation of Employee Stock Options

Of significant concern to many in the business community, the new Government has proposed to limit the deductions that a person may claim in connection with the exercise of employee stock options.

The Income Tax Act currently provides that when an employee is granted certain stock options, the employee is not immediately required to recognize a taxable benefit from employment. However, when the options are subsequently exercised (or, in the case of options relating to shares of certain "Canadian-controlled private corporations" ("**CCPCs**"), when the shares acquired on the exercise of the options are subsequently sold), a taxable benefit from employment is required to be recognized by the employee. The amount of the taxable benefit is generally equal to the value of the shares acquired on the exercise of the option, less the amount paid to acquire the shares.

As a means of encouraging employees to hold equity interests in their employers, the *Income Tax Act* currently provides that, under certain circumstances, an employee may claim a deduction equal to 50% of the taxable benefit that arises in connection with the exercise of a qualifying employee stock option (the "**Stock Option Deduction**").[1] (In effect, the Stock Option Deduction results in the taxable benefit being subject to tax at rates comparable to those that would have applied if the benefit was instead treated as a capital gain.)

While the new Government has indicated that it recognizes the importance of maintaining the Stock Option Deduction, it has claimed that the benefit of the Stock Option Deduction has been disproportionately enjoyed by a small number of taxpayers. On that basis, the Government proposed in its election platform that taxpayers only be permitted to claim the Stock Option Deduction in respect of the first $100,000 (US$75,000) of annual gains arising from the exercise of employee stock options. The amount of any such annual gains in excess of $100,000 would be required to be fully recognized as taxable income, without any offsetting deduction.

Planning Considerations

The new Government initially offered few details on how the proposals affecting the Stock Option Deduction will be implemented. However, on November 20, 2015, the new Minister of Finance indicated that it was not the Government's intention to amend the rules governing the taxation of employee stock options on a retroactive basis. According to the Minister, "any decision we take on stock options will affect stock options issued from that date forward" and "any stock options that have been issued prior to that date will be under [the] taxation regime that was in effect prior to that date".

The Minister's comments appear to indicate that employee stock options issued prior to the release of more detailed legislative proposals will be "grandfathered" and will not be subject to the contemplated limitations on the ability to claim the Stock Option Deduction.

Prior to the Minister's announcement, option holders had been left to consider whether it might be prudent to exercise their options before the expected tax changes took effect. The early exercise of options carried certain risks that extended beyond the simple risk of potentially accelerating a taxable benefit unnecessarily if existing options were ultimately "grandfathered" from the proposed tax changes. For instance, where an option holder does not intend (or is not permitted) to immediately sell the shares acquired on the exercise of an option, any subsequent loss on the later sale of the shares cannot be carried back to offset the initial taxable benefit. As a result, the early exercise of a stock option could give rise to immediate taxable income that cannot be reduced in the future by losses arising on the ultimate sale of the shares.

The Minister's recent announcement should provide comfort to most option holders that it is not necessary to exercise existing options early to ensure that the Stock Option Deduction may be fully claimed in respect of such options. Nevertheless, certain option holders may still wish to consider the prudence of exercising options in advance of the impending 4% increase in the highest marginal personal income tax rate (as discussed in more detail below).

The Minister's recent comments appear to suggest that the new Government may take some time to assess how it wishes to adjust the rules governing the taxation of employee stock options. For instance, will limitations on the ability to claim the Stock Option Deduction ultimately apply in respect of all options or will there be an exemption for options in respect of shares of CCPCs or companies that operate in sectors that have traditionally relied heavily on stock option compensation (e.g., technology start-ups)?

The announcement of "grandfathering" relief may also offer special planning opportunities for businesses, albeit for a short period of time. Businesses that have been considering granting stock options to employees may wish to consider expediting such grants to ensure that employees will be able to fully claim the Stock Option Deduction in respect of such new options in the future.

Businesses that grant significant employee stock options may wish to begin considering alternative compensation plans as a means of providing ongoing incentives to those employees that might cease to be able to fully avail themselves of the Stock Option Deduction in the future.

Corporate taxpayers are not entitled to claim a deduction in respect of the value of shares issued on the exercise of stock options when computing their income. If the ability to claim the Stock Option Deduction is limited, businesses may begin to reassess the advantages and disadvantages of granting stock options relative to other forms of employee remuneration. Alternative equity-based compensation programs, which track the equity value of an enterprise, yet entitle the company to claim a deduction in respect of payments made to participating employees, may soon represent a more tax-efficient mode of compensation. Employers with significant stock option programs would be well advised to begin reviewing their stock option plans at the earliest opportunity to mitigate the impact of the impending changes to the Stock Option Deduction.

*(ii) Changes to the Employment Insurance ("**EI**") Program*

The Liberal Party also proposed a number of significant changes to the EI system during the election campaign.

First, the Liberals indicated that they would scale back previously proposed reductions to EI premiums. In its 2015 Budget, the former Conservative Government had projected that EI premiums would fall to $1.49 per $100 of remuneration by 2017. The new Government has proposed to limit the reduction in EI premiums to a revised level of $1.65 per $100 of remuneration earned.

Second, the Liberals have proposed to grant employers an exemption from employer-side EI premiums in respect of certain new hires. Specifically, under the proposal, employers that hire a person between the ages of

18 and 24 into a permanent position in 2016, 2017 or 2018 will enjoy a 12 month exemption from having to pay employer-side EI premiums in respect of the employee.

Third, the Liberals have proposed to extend the period during which an individual may obtain EI benefits during a parental/maternity leave from 12 to 18 months (albeit on a reduced basis). (The new Government has acknowledged that the implementation of this latter proposal will require the cooperation of the provinces and amendments to the provincial labour codes.)

Planning Considerations

Employers that intend to hire younger workers into permanent positions may wish to consider delaying the initial retention of such new employees until 2016 in order to take advantage of the promised EI premium holiday. However, employers will need to exercise caution in trying to take advantage of the new incentive. In particular, human rights legislation precludes employers from discriminating between prospective employees on the basis of age. While it may be possible to assess the eligibility of an applicant for the new EI incentive without violating human rights legislation, questions will need to be carefully considered prior to being posed to applicants.

(iii) Other Commercial Tax Changes

The new Government has proposed other tax changes with a view to stimulating economic activity. For one, the new Government proposes to provide a full federal GST rebate in respect of expenditures on new capital investments on affordable rental housing. While further details on the expenditures that will qualify for the rebate have yet to be released, a footnote to the Liberal Party's election platform seems to suggest that the rebate will be modeled on the existing partial rebate under the current law.

The Liberal Party has also proposed to reverse the legislated phase-out of the tax credit offered in respect of the acquisition of shares of "prescribed labour-sponsored venture capital corporations" and immediately reinstate the full 15% federal tax credit. (In 2013, the federal Government proposed to phase-out the tax credit over a four-year period.) It will be interesting to observe whether parallel provincial tax credits, which were previously phased-out, might be re-introduced in light of the new federal proposal.

Personal Tax Changes

A central theme of the Liberal Party's election platform was increasing taxes, and reducing tax benefits, for those individual taxpayers with incomes in excess of $200,000 (US$150,000) per year.

In this regard, the Liberal Party pledged to introduce a new top federal marginal tax rate of 33%, which will apply to personal income that exceeds $200,000 each year. When combined with applicable provincial income tax rates, the combined top marginal tax rate that will apply to taxpayers in many provinces will exceed 50%, with the rate in one province approaching 59%.

The Liberal Party also proposed to repeal the rules in the *Income Tax Act* that permit certain "income splitting" between spouses. The "family income splitting" provisions, which were first introduced in 2014, effectively permit an individual with a child under the age of 18 to transfer up to $50,000 of his/her income to a lower-earning spouse for federal income tax purposes (for a maximum federal tax savings of $2,000 per year).

Finally, the new Government has proposed to reduce the annual limit on the contributions that individuals may make to a Tax-Free Savings Account from the current limit of $10,000 to $5,500.

Planning Considerations

Taxpayers may wish to consider the prudence of (i) accelerating the receipt of income in 2015, or (ii) delaying the recognition of expenses or deductions to a later taxation year. For instance, taxpayers may wish to consider accelerating the receipt of bonuses or the disposition of property with accrued gains prior to the increase in personal income tax rates. In a similar vein, taxpayers may wish to consider means of maximizing the benefit of the "family income splitting" provisions by managing their income relative to that of their spouse before the provisions are repealed.

Although taxpayers might be eager to take steps to mitigate the impact of the impending personal income tax changes, taxpayers should exercise caution before taking steps to increase their 2015 income. To date, few details have been provided on how, or when, the proposed tax changes will become effective. Particular attention should be paid to all upcoming governmental announcements to determine the effective date of the expected tax changes. Ultimately, each taxpayer will need to carefully weigh the relative risks and advantages that might accrue from accelerating income, particularly in cases where future income or salary levels might be uncertain.

General Tax Policy Statements – Foreshadowing Things to Come?

The new Government's election platform also contained a series of general statements that provide some indication of where future tax changes may emerge.

For instance, the Government has signalled a desire to introduce enhanced tax measures to generate more clean technology investments in Canada. The new Government's stated objective is "to make Canada the world's most competitive tax jurisdiction for investments in the research, development, and manufacturing of clean technology".

The new Government has also repeatedly expressed a desire to review all existing tax expenditures to "target tax loopholes that particularly benefit Canada's top one percent". The Government has suggested that the "core objective" of the review will be to "look for opportunities to reduce tax benefits that unfairly help those with individual incomes in excess of $200,000 per year". The proposed limitations to be imposed on the Stock Option Deduction have been cited as one example of the changes that will be made as part of the tax expenditure review.

The new Government has further suggested that it may introduce more restrictive rules governing the taxation of CCPCs.

The new Government has projected that it will be able to generate $6.5 billion in savings and increased tax revenue over the next four years as a consequence of its review of existing tax expenditures and spending policies. The new Government has also pledged to allocate an additional $80 million over the next four years "to help the Canada Revenue Agency crack down on tax evaders".

Planning Considerations

The new Government's stated focus on tax planning and closely-held business corporations suggests that taxpayers should expect increased audit activity in the coming years. Taxpayers should take steps to ensure that their previous tax plans have been executed and administered in the manner intended, and future tax planning should be undertaken with an eye to the Government's pending legislative proposals.

1 In the Province of Québec, for provincial tax purposes, the available deduction is equal to 25% of the taxable benefit.

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.