Proposed Changes to the Tax Treatment of Employee Stock Options

On June 17, the Department of Finance (DOF) released long-awaited draft legislation that will limit the current preferential tax treatment of stock options in an effort to create a "fairer" tax regime. According to the DOF, the tax benefits of the current employee stock option deduction "disproportionately accrue to a very small number of high-income individuals."

Here are the key takeaways:

When: The new tax regime will apply to options granted on or after **January 1, 2020**.

Applies to: Corporations and Mutual fund trusts. It does not apply to Canadian-controlled private corporations (CCPCs) and non-CCPCs that are emerging companies such as "start-ups, emerging or scale-up companies" that meet the not-yet-drafted, prescribed conditions. Stakeholders can submit comments on the conditions for this purpose to the DOF until September 16, 2019.

Current tax treatment: The current tax rules provide employee stock options with preferential personal income tax treatment in the form of a stock option deduction. Generally, employees who acquire an employer share under a qualifying stock option agreement recognize a taxable stock option benefit equal to the difference between the fair market value (FMV) of the share and the exercise price (that is, the "spread"). Assuming certain conditions are met, the employee is eligible for a 50% offsetting deduction from the stock option benefit for tax purposes (such that the employee is effectively being taxed at the same rate as capital gains). Note the employer is ***not*** entitled to a corporate tax deduction in respect of shares issued under such an agreement. There is currently no limit to the benefit that can be realized by the employee.

Proposed tax treatment: Only "qualified options" (that is, options that vest in a calendar year with a value limited to $200,000) will be eligible for the current preferential tax treatment. The value will be determined using the FMV of the share price on the date of grant. Non-qualified options (that is, those that exceed the annual vesting limit of $200,000) will be fully taxable at ordinary income tax rates. The employer corporation will be entitled to a deduction with respect to shares issued under the non-qualified options only. Employers may designate qualified options as ineligible for the employee stock option deduction so that the employer may instead claim a corporate tax deduction.

Whether an option is eligible for preferential treatment will be determined in the year of grant — although the stock option benefit won't be realized until the option is exercised. Note the following:

- The "vesting year" for purposes of the annual cap will be the year in which the stock option agreement states the option may be exercisable (otherwise than as a consequence of an event that is not reasonably foreseeable at that time). This may create uncertainty as to whether the option will qualify if it becomes exercisable through an event such as a change-in-control.

- Where there are annual grants with overlapping vesting, those options that are granted first will be first considered for purposes of the $200,000 vesting limit.

- If an employee has a number of otherwise identical stock options but some are qualified and others are non-qualified, the employee will be considered to exercise the qualified options first.

Finally, employers must notify employees in writing, at the time of grant, whether options are subject to the new rules, and must notify the Canada Revenue Agency in prescribed form.

Proposed Tax Treatment Scenarios

The following is a simple illustration with one grant in two different exercise scenarios.

Facts: On January 1, 2020, Employer XCo grants the employee 200,000 options having an exercise price equal to $25 (that is, the FMV of the share on the date of grant). The options will vest in equal parts over four years. Each year, 8000 options are qualified options ($200,000 limit/$25 FMV at grant) and 42,000 options are non-qualified.

1. Annual Exercise

- On January 1, 2021, 50,000 options vest and the FMV of the share is $30. The employee exercises all 50,000 options and recognizes a taxable benefit based on the spread of $250,000 (that is, 50,000 x $5).
- $40,000 (8,000 x $5) of the taxable benefit will be eligible for the preferential tax treatment, and the employee may claim a 50% stock option deduction of $20,000.
- $210,000 (42,000 x $5) of the taxable benefit will be taxable as ordinary income. XCo may claim a tax deduction of $210,000.
- On January 1, 2022, another 50,000 options vest, and the FMV of the share is $40. The employee exercises 50,000 options and recognizes a taxable benefit of $750,000 (that is, 50,000 x $15).
- $120,000 (8,000 x $15) of the taxable benefit will be eligible for the preferential tax treatment, and the employee may claim a 50% stock option benefit deduction of $60,000.
- $630,000 will be taxable to the employee as ordinary income; XCo may claim a tax deduction of $630,000.

2. Postponed Exercise

- On January 1, 2021, 50,000 options vest, but the employee does ***not*** exercise any options — there is no taxable event — 8,000 qualified options are on the table.
- On January 1, 2022, another 50,000 options vest, and the FMV of the share is $40. The employee exercises 50,000 options and recognizes a taxable benefit of $750,000 (that is, 50,000 x $15).
- $240,000 (16,000 x $15) of the taxable benefit will be eligible for the preferential tax treatment, and the employee may claim a 50% stock option benefit deduction of $120,000.
- $510,000 will be taxable to the employee as ordinary income; XCo may claim a tax deduction of $510,000.

Implications

With fewer options qualifying for preferential (employee) tax treatment, employers may want to revisit their current long-term incentive (LTI) vehicle mix.

Organizations may look at this as an opportunity to focus on vehicles that are most in line with their business strategy and competitive practice. For example, employers may consider using fewer options and, instead, establishing longer-term share unit plans (that is, beyond the typical three-year performance period) that would be settled with treasury shares. It is unlikely the proposed legislation will result in stock options disappearing as a popular LTI vehicle; notably, the US has a similar stock option tax regime (in that preferentially taxed “incentive stock options” are subject to a FMV $100,000 annual vesting limit, while the more-popular “non-qualified stock options” are fully taxable), and options continue to remain a viable element of executive compensation.

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