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Legal update

Taking stock: an update on the new proposed Canadian federal income tax rules for employee stock options

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Tax

On June 17, 2019, the Department of Finance (Canada) released draft legislation that would, if implemented, limit the current preferential tax treatment of employee stock option benefits. Though first floated by the Liberal Party of Canada during the 2015 Canadian federal election campaign, the specific proposals were only formally presented in the March 2019 federal budget.

Broadly, these new proposals:

- Place a $200,000 cap on the value of shares that may vest to an employee in a year and still be eligible to receive the current 50% deduction on employee stock options.
- Provide a deduction for employers for shares issued to an employee where the 50% deduction is not available.
- Impose additional reporting and tracking requirements for employers for each grant of options.

These proposals apply to options granted on or after January 1, 2020. None of the elements of the proposals apply to option grants from Canadian-controlled private corporations (CCPCs) or corporations that meet certain (yet undefined) "prescribed conditions" (referred to in this article as "prescribed corporations").

As the Parliament of Canada has commenced its summer recess, only to return to the expected call for an election in the fall, the timing of the passage of these proposals is uncertain. Notwithstanding this uncertainty, the Department of Finance (Canada) will accept comments from stakeholders on establishing the prescribed conditions until September 16, 2019.

Current rules

Under the existing stock option rules, if an employee acquires a share, the difference between the fair market value at the time of the exercise of the option and the amount paid by the employee to acquire that share is treated as a taxable employment benefit. However, there is a “stock option deduction” equal to 50% of that employment benefit. Most stock option plans are designed so that this deduction is available to employees. The effect of the stock option deduction is such that the option benefit is taxed at the same effective rate as a capital gain.

Impacts on employees

The proposals would operate to limit the number of shares eligible to receive the stock option deduction in a particular taxation year. Any taxable employment benefit received on shares above the new limit would be fully included in income without the benefit of the 50% deduction.

The proposals refer to shares that exceed the cap and are not eligible for the stock option deduction as "non-qualified securities." The $200,000 cap is calculated by multiplying the value of each share (at the date of grant) by the number of shares that vest in the year, and any shares that exceed that limit are then classified as non-qualified securities.

For example, an employee is granted an option for 25,000 shares with a fair market value of $10 per share on the date of grant. If all the shares vest in Year 1, 20,000 would be eligible for the stock option deduction (20,000 x $10 = $200,000), while the remaining 5,000 would be treated as "non-qualified securities" with the employee benefit taxed at 100% at the time of exercise without the benefit of the 50% deduction. This is regardless of when those shares are exercised.

From the perspective of the employee:

- An employee can exercise options that may qualify for the stock option deduction before non-qualified securities.
- The cap is calculated per employer, so if an employee (including directors) has stock options from multiple employers, the $200,000 cap applies separately for each employer.

Impacts on employers

Under these proposals, an employer can generally deduct the amount received as a benefit by an employee if the share is a non-qualified security, but only if: (i) the employer was not a CCPC or a prescribed corporation; (ii) the share was eligible for the stock option deduction; (iii) the employer was the employer of the individual receiving the share at the time of issuance; and (iv) the employer met the new reporting requirements.

The proposals impose two new reporting requirements on employers. First, employers must inform the employee at the time of grant if a share will be a non-qualified security. Second, the employer must notify the Canada Revenue Agency that a share will be a non-qualified security. These obligations will require an employer to carefully track options granted to an employee so that they can calculate, for each grant, whether the employee has reached his or her $200,000 limit.

Request for comment

The Department of Finance (Canada) has requested comments on the requirements to be a prescribed corporation. The government's stated goal in implementing these rules is to stop executives at "large, long-established, mature firms" from using stock options as a tax-preferred method of compensation, while maintaining preferential tax treatment of employee stock options to support younger and growing Canadian businesses. This goal is why CCPCs are excluded from the rules, but it is recognized that there may be scenarios in which a non-CCPC would meet the government's criteria for firms that should have unlimited access to the preferred treatment. The government has given no suggestion as to what the basis of these prescribed conditions will be, only referring to "start-up, emerging, and scale-up companies" in its press bulletin.

Employers should consider their existing stock option plans and contemplated option grants to assess the impact that these proposals could have on them and their employees.

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