Employee stock option taxation in Canada: A refresher for employers

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This article summarizes the tax treatment of employee stock options in Canada (and other stock-based awards) granted after June 30, 2021.

Background

As of July 1, 2021, Canada introduced new rules (the New Rules) for options granted by corporations that are not Canadian-controlled private corporations (CCPCs) and corporations whose annual gross revenue determined on a consolidated group basis is C$500 million or more. For options granted prior to July 1, 2021, and for options granted by corporations that after that date do not fall within these two categories, the rules applicable taxation of employee stock options (the Old Rules) have not changed.

Old Rules

Under the Old Rules, when an employee exercised a stock option agreement, the employee would be deemed to realize a taxable employment benefit equal to the fair market value of the shares received less the exercise price paid together with any amount paid by the employee on the grant of the option. In certain circumstances, the employee is eligible to claim a deduction equal to 50 per cent of the taxable employment benefit (the Stock Option Deduction). The impact of the Stock Option Deduction allows the taxable employment benefit to be taxed at the same effective rate as capital gains.

A Stock Option Deduction is available if all of the following requirements are met:

- the exercise price is not less than the fair market value of the share at the time the option was granted;
- the employee was dealing at arm's length with the employer immediately after the option was granted to them; and
- the share on which the option is granted must be a "prescribed share", which in essence means a "plain vanilla" common share that has no special guarantees, rights or features either under the corporation's articles or by virtue of any agreement in respect of the share.

Two special rules apply to stock options granted by a CCPC:

1. the taxable employment benefit amount is not included in income until the year in which the employee disposes of the optioned shares; and
2. if certain conditions are met, a second alternative 50 per cent deduction may be available if the option is granted by a CCPC to an arm's length employee and the employee holds the shares for at least two years of acquiring them.

This enables employees to receive shares with a discounted option price (disqualifying them for the general 50 per cent deduction) and still access the alternative CCPC deduction.

Under the Old Rules, no tax deduction was available to the employer in respect of stock options granted to employees.

New Rules

As of July 1, 2021, the New Rules limit the availability of the Stock Option Deduction to an annual maximum of $200,000 in a calendar year (the Annual Vesting Limit) calculated based on the fair market value of the underlying securities on the date of the grant. Options that exceed the $200,000 threshold are "non-qualified securities" and thus do not qualify for the Stock Option Deduction. The Annual Vesting Limit applies to an employee for each separate employer, however, options issued by several non-arm's length employers are aggregated in calculating the $200,000 Annual Vesting Limit.

The Annual Vesting Limit is based on the portion of underlying shares with a fair market value in excess of $200,000, valued as of the date the option agreement is made, per vesting year of the option. All options vesting in the same year are aggregated for purposes of the overall $200,000 limit. A "vesting year" is defined as the first year during which the option becomes exercisable per the option agreement. A single option grant may have multiple vesting years (for example, an option may vest 20 per cent per year over a five year period), but multiple grants over several years can give rise to options granted in different years having the same vesting year.

If the option agreement does not specify a vesting year, the option will be considered to vest on a pro rata basis beginning the day the agreement was entered into and ending the earlier of the day that is 60 months after the day the agreement was entered into, or the last day that the right to acquire the security could become exercisable under the agreement. When an employee exercises some but not all of their options, they are considered to acquire shares that are qualified securities first, before acquiring any non-qualified securities.

Employers subject to the New Rules can designate securities to be non-qualified securities if they wish. Where this designation is made, employees will not be entitled to a Stock Option Deduction, but the employer will be entitled to a deduction for the amount of the taxable employment benefit.

Notice and tracking obligations

Employers have notification and reporting obligations associated with both the Old Rules and the New Rules. For stock option agreements entered into after June 30, 2021, employers must inform their employees in writing no later than 30 days after the stock option agreement is entered into of the any shares that are considered "non-qualified securities" (including designated shares and share exceeding the Annual Vesting Limit). Additionally, employers must notify the Canada Revenue Agency of the issuance of securities options for non-qualified securities on Form T2 Schedule 59 with their tax return.

Illustration of New Rules

Leslie is an employee of Xco, a company that is subject to the New Rules. Leslie's employer does not designate the securities to be non-qualified securities.

In 2022, Xco granted Leslie options to acquire 20,000 shares, to vest evenly over a period of four years, with 5,000 options vesting in each of 2023, 2024, 2025 and 2026. The exercise price is $45 per share, which is the fair market value underlying Xco shares at the time the options are granted.

The following year, in 2023, Xco grants Leslie options to acquire another 20,000 shares vesting over a similar four-year period at exercise price of $40 per share as the fair market value of the underlying Xco shares had not changed.

In this example, the 2022 grant will partially exceed the Annual Vesting Limit (*i.e*. $45 x 5,000 shares = $225,000) for each of the 2023 to 2026 years. Further, the entire 2023 grant will exceed the Annual Vesting Limit for the 2024 to 2026 years, and will partially exceed the Annual Vesting Limit in 2027. Leslie will not be able to claim the Stock Option Deduction on the excess amount.

Xco would have to notify Leslie of the non-qualified securities within 30 days after the stock option agreement was entered into.

Other share-based awards

Although these rules were designed with traditional stock options in mind, they can apply to other stock based awards. Designations may be appropriate for other stock based awards (where the Stock Option Deduction would not be available) – such as certain restricted share units awards – to ensure the employer deduction is available.

Recommendations to employers

We recommend that employers take the following steps to comply with the new rules:

1. At the time of grant:
    a. Identify any non-qualifying securities (*i.e.* securities grants above the $200,000 Annual Vesting Limit); and
    b. For securities grants below the annual $200,000 Annual Vesting Limit determine whether to designate these otherwise qualifying securities as non-qualifying securities. If the employer makes this designation, they will

be entitled to a deduction equal to the amount of any benefit realized by the employee, however, the employee will not be entitled to claim the Stock Option Deduction (50 per cent Deduction).

2. Within 30 days after the award agreement is entered into with an employee, notify them of any awards that exceed the Annual Vesting Limit and any awards designated by the employer as non-qualifying securities. It would be prudent to amend the stock option grant agreement with this information so that the deadline is not missed inadvertently.
3. Coordinate a protocol between the human resources and tax department to support information sharing and ensure that the employer tracks both grants and award exercise events and ensures that payroll tax withholdings are taken at the correct income tax rate for any exercises resulting in non-qualifying securities being issued. This is also necessary to confirm the available employer deduction.
4. Notify the Canada Revenue Agency of the issuance of securities options for non-qualified securities on Form T2 Schedule 59 with their tax return.
5. The employer to consider appropriate financial accounting treatment of non-qualifying securities (*e.g*. whether to calculate a deferred tax asset for non-qualifying stock options).

For any questions on employee stock option taxation, please reach out to one of the key contacts listed below.

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