Employee Stock Options: Canadian Tax Changes Coming in March?

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Many employers grant options to their employees to buy stock of the employer as a form of compensation. Employee stock options are favourably taxed under the *Income Tax Act* (Canada).

When a corporation grants an employee the right to buy its shares, the price at which the employee can buy the shares (the exercise price) is usually equal to the fair market value of the employer's shares at the date the option is granted. No taxable event occurs when the option is granted. If the underlying shares increase in value after the option is granted; the employee will typically exercise the option, pay the exercise price, acquire the shares, and enjoy a benefit equal to the difference between the value of the shares on the date of exercise and the exercise price (known as the in-the-money amount).

For tax purposes, the in-the-money amount is reported as a taxable benefit and included in the employee's income when the option is exercised.1 The employee is entitled to deduct 50% of the benefit in computing his or her taxable income under a deduction for qualifying stock options in two cases:

1. the shares receivable under the options must be ordinary common shares with no fixed entitlements under the share terms or any related agreements, and the option exercise price cannot be less than the fair market value of the shares at the date of the option grant (i.e., the options must not have been in-the-money when granted);2 or
2. the shares received under the options are shares of a CCPC, and the employee holds those shares for at least two years.

In such cases, the employee receives a benefit of which only half is taxable, such that the effective rate of tax is 50% of what it would otherwise be.3 The employer cannot claim a deduction for any part of the value of the shares issued to the employee,4 and must make normal payroll remittances on the taxable income arising from exercising the options even if the employee receives no cash.

In the October 2015 federal election campaign, the Liberal Party of Canada included a commitment to limit the amount qualifying for the 50% stock option deduction to $100,000 per year:5

A starting point would be to set a cap on how much can be claimed through the stock option deduction. The Department of Finance estimates that 8,000 very high-income Canadians deduct an average of $400,000 from their taxable incomes via stock options. This represents three quarters of the fiscal impact of this deduction, which in total cost $750 million in 2014. Stock options are a useful compensation tool for start-up companies, and we would ensure that employees with up to $100,000 in annual stock option gains will be unaffected by any new cap.

New Liberal Finance Minister Bill Morneau subsequently announced that any changes to the taxation of stock options would not be retroactive, saying to reporters, "I would like those Canadians who are concerned about this issue to understand that any decisions we take on stock options will affect stock options issued from that date forward."6

As such, there would not appear to be any need to take action on existing stock options, although companies using stock options to compensate Canadian employees may wish to ensure that any new option grants are made before the date of the upcoming federal budget, which is anticipated to be delivered the week of March 21.7 Companies will also want to consider the possibility of examining other forms of employee compensation that are tax-deductible, a possibility that does not seem to have been incorporated into the government's estimate of the fiscal impact of capping the 50% stock option deduction. In fact, one study suggested that as employers respond by moving to tax-deductible forms of executive compensation, restricting the 50% stock option deduction might actually cost the government money.8 The government's treatment of this issue will be watched carefully by the business community.

1 If the option is to acquire shares of a "Canadian-controlled private corporation" (CCPC), the taxable benefit is not included in the employee's income until the shares acquired by exercising the option are sold.

2 The details of these qualifying conditions are more complex, and should always be reviewed carefully.

3 This is sometimes referred to as "capital gains treatment", although this is not quite true: the taxable benefit is not a capital gain and so cannot be offset by capital losses.

4 Where the stock option is surrendered for a cash payment instead of being exercised, the employer must agree not to claim any deduction for the payment in order for the employee to be able to claim the 50% stock option deduction.

5 "The Liberal Fiscal Plan and Costing"

6 www.reuters.com/article/2015/11/20/canada-budget-options-idUSL1N13F1HM20151120

7 https://business.financialpost.com/news/economy/finance-minister-bill-morneau-to-present-federal-budget-week-of-march-21-sources

8 See Mintz and Venkatachalam, "Taxing Stock Options: Efficiency, Fairness and Revenue Implications" (October 2015)

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