Canadian government proposes legislation restricting employee stock option deductions

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What You Need to Know

- Currently, employee stock options that meet certain prescribed conditions can qualify for capital gains-like tax treatment by virtue of the stock option deduction.
- In the 2020 Fall Economic Statement, the Government of Canada released draft legislation to limit the stock option deduction where options exceeded a $200,000 annual cap.
- This $200,000 annual vesting cap would be calculated on the fair market value of the underlying shares on the date the options were granted.
- The annual cap will apply to non-CCPC employers with annual gross revenues in excess of $500 million.
- The revised draft legislation will apply to employee stock options granted after June 2021.
- Now is the time for employers to grant options in advance of the new rules and to put systems in place in order to track the annual vesting amounts of employee stock options previously granted.

Introduction

In addition to salary and bonus payments, Canadian employers use a variety of equity compensation awards to attract and retain key employees. Granting stock options is a commonly used type of equity compensation award because, in part, they can benefit from a special tax regime.

The current regime

Under the current regime, employer grants of stock options, usually subject to vesting conditions, are not taxable to employees upon grant. Once the options have vested, the employee has the right to exercise the options to receive shares in the underlying company at a pre-determined price (typically the fair market value of the shares at the time of grant).

Once exercised, a taxable employment benefit is included in the employee's income equal to the gain on the fair market value of the shares from the date of grant to the exercise date, less the exercise price paid by the employee. So long as certain prescribed conditions are met, an arm's-length employee is generally able to deduct half of the taxable employment benefit (the Stock Option Deduction). The Stock Option Deduction grants preferential tax treatment on employment income arising from stock options, taxing the employment benefit at the same effective rate as capital gains.

No tax deduction is available to the employer in respect of stock options granted to employees.

The government 's 2019 proposal

In the 2019 federal budget, the government proposed restricting this preferred tax treatment on certain employee stock options. Under the proposal, options granted by corporations and mutual funds considered 'large, long-established mature firms' would not qualify for the Stock Option Deduction where the options exceeded a $200,000 annual cap. This $200,000 annual vesting cap would be calculated on the fair market value of the underlying shares on the date the options were granted. This cap would not apply to options granted by Canadian Controlled Private Corporations (CCPCs), start-ups, or emerging and scale-up companies.

Employers would be entitled to deduct the employment benefit on stock options for corporate income tax purposes to the extent the Stock Option Deduction was unavailable to the employee because the vesting exceeded the $200,000 annual cap. Alternatively, employers with stock options captured under the proposal would have also had the right to designate stock options as non-qualifying, rendering them ineligible for the Stock Option Deduction and allowing the employer to deduct the employment benefit in the year it is included in the employee's income.

The proposals would have applied to employee stock options granted by corporations and mutual fund trusts on or after Jan. 1, 2020. However, Finance Canada quietly halted the proposed changes on Dec. 19, 2019, following stakeholder consultation. The proposed changes would not only increase the tax burden of certain employees but also would have greatly increased employer compliance cost. Employers would have been obligated to not only trace multiple trenches of qualifying and non-qualifying options but also to:

- notify employees in writing of any options exceeding the annual cap or which have been designated as non-qualifying options, and;
- alert the CRA of any non-qualifying options in prescribed form filed with the annual corporate or trust returns.

The 2020 fall fiscal update

The Canadian government, in its 2020 Fall Economic Statement, introduced revised draft legislation to limit the availability of the stock option deduction.

The revised draft legislation is similar to the 2019 proposals, but provides welcome clarification. Employee stock options eligible for the Stock Option Deduction will be limited to the annual cap of $200,000, as previously announced, which includes all stock option agreements between the employee and the employer or another corporation with which the employer does not deal at arm's length. Where an individual has two or more arm's-length employers, the individual will have a separate $200,000 limit for each of those employers.

The ability for subject employers to designate all stock options as non-qualifying remains unchanged in the new proposed legislation.

Consistent with the prior announcements, the new rules will not apply to CCPCs. The revised draft legislation also clarifies which employers will constitute 'large, long-established mature firms.'

Generally, the new rules would apply to employers that are corporations or mutual fund trusts with annual gross revenue exceeding $500 million in the last fiscal year. However, employers that do not generate more than $500 million in revenue will generally not be subject to the new rules. The revenue test will be applied on a rolling annual basis and determined based on the consolidated financial statement of the employer or, where applicable, the corporate group.

Looking forward

The revised draft legislation will apply to employee stock options granted after June 2021. As such, now is the time for employers to grant options in advance of the new rules and to put systems in place in order to track the annual vesting amounts of employee stock options previously granted.

It will be important for employers to establish review processes to ensure they confirm whether they will be subject to the new rules annually. Employers who are members of a corporate group must consider the consolidated financial statements and those employers who have employees receiving employee stock options from another non-arm's length corporation must be careful to ensure the cumulative vesting amount is considered.

If you have any questions or would like to discuss your specific circumstances, reach out to BLG's Tax Group or any of the key contacts listed below.

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