Upcoming Changes to the Taxation of Employee Stock Options

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In Budget 2019, the Government of Canada announced its intention to limit the current employee stock option tax regime, moving towards aligning Canada's tax treatment of such options with the United States. On Monday, June 17, 2019, the Minister of Finance tabled a notice of ways and means motion in the House of Commons to amend the *Income Tax Act* to cap the tax benefits associated with stock options. A consultation with industry on the new measures has commenced and will end on September 16, 2019.

Current Rules

Canada's existing regime provides relatively favourable tax treatment for employee stock options. When stock options are granted by a corporation, employees do not face immediate tax consequences; rather, employees who are granted stock options are subject to tax on the difference between the fair market value (FMV) and exercise price of the shares subject to the option (such difference referred to as the option benefit), determined as at the date of exercise of the option. If certain conditions are met, employees can deduct one-half of the option benefit. This results in the optioned benefit being taxed at the same effective rate as capital gains. The option benefit is generally subject to tax in the year the option is exercised. However, in the case of stock options granted by a Canadian-controlled private corporation (CCPC), the taxation of the option benefit is deferred until the time of disposition of the optioned shares. Except in very limited circumstances, employers are generally not entitled to a deduction in connection with stock options.

By way of example, consider an employee who is granted a stock option to purchase 1,000 shares of a company at a value of $1,000 per share in year 1. The employee exercises the stock option in year 2, buying the shares for $1,000,000 when the fair market value (FMV) of those shares is $1,500 per share, and disposes of them in year 4, when the FMV of the shares is $1,800 per share. There are two possible treatments of the stock options under current legislation:

- If the employer is not a CCPC: The employee will realize a taxable employee benefit in year 2 on the option benefit (*i.e.,* difference between the FMV of the shares on the date of exercise and the exercise price of $500,000). Assuming the conditions are satisfied, the employee is also entitled to a deduction of one-half of the benefit, or $250,000. In year 4, when the employee disposes of the shares at a price of $1,800 per share, the employee will realize a capital gain equal to the difference between the FMV of the shares on the date of exercise ($1,500) and the FMV of the shares on the date of disposition. One-half of the capital gain (*i.e.* ($1800-$1500) x 1000 / 2 = $150,000) is included in the employee's taxable income.

- If the employer is a CCPC: The employee is entitled to defer the taxation of the employment benefit until year 4 when the employee disposes of the shares. The employee will be taxable on an employment benefit of $500,000 (which was crystallized as of year 2), and is entitled to a deduction of one-half of the benefit, or $250,000. The difference between the disposition price of the shares ($1,800) and the FMV of the shares at the time the option is exercised ($1,500) is a capital gain which is taxed in the manner described above.

Upcoming Changes

Further to the Notice of Ways and Means, the following changes will take effect effective January 1, 2020:

- Stock option grants which are eligible for a deduction will have an annual limit of $200,000 (based on the FMV of the shares at the time of the grant).
- The limit will not apply to options granted by CCPCs.
- The new rules will not apply to so-called start-ups, emerging or scale-up companies, even if those companies are not CCPCs.

In the above example, where the company is not a CCPC, the preferential treatment will only apply to $200,000 of the initial stock option grant of $1,000,000. As such, in year 2, at the time of exercise, the employee can deduct a maximum of one-half of $100,000, representing the growth in the value of $200,000 of the shares granted in year 1. The employee will now be taxed on an employment benefit of $450,000 in year 2, rather than being taxed on $250,000.

Of note is that employers will now be able to deduct stock option grants (or portions thereof) which are no longer eligible for the deduction.

The exemption for CCPCs is a welcome clarification from the government. It is often very difficult to determine the value of private company shares, and stock options are a very effective mechanism for compensating employees of private companies. If the new rules were to apply to private companies, the administrative and compliance costs could create an undue burden.

Similar issues may be faced by certain non-CCPCs, such as small public issuers (such as TSX-V or CSE listed companies) and Canadian private companies that are not Canadian-controlled (for example, those with non-resident parents), or companies that are not technically "private" for tax purposes even though they are private from a corporate/securities perspective (for example, companies controlled by a public corporation or those which elect to be treated as a public corporation for tax purposes). The government has proposed an exemption for "start-ups, emerging, or scale-up companies" that are not CCPCs, presumably to alleviate the burden on some of these companies.

At this time, it is not clear what criteria will be applied to determine whether a company will qualify as a start-up, emerging, or scale-up company. The Ministry of Finance has invited stakeholders to provide their views on these criteria, as well as on the compliance and administrative processes associated with the change in legislation, by no later than September 16, 2019. If you would like further information regarding the process or assistance with making submissions to the Department of Finance, please contact the BLG Tax Team.

By

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