WeirFoulds LLP

Budget 2019 In-Depth: Pending Proposals to Limit Preferential Tax Treatment of Employee Stock Options

March 22, 2019

By Ryan Morris

The 2019 Federal Budget announced the Canadian government's intent to limit the preferential tax treatment afforded to employee stock options that are granted to "high income individuals employed at large, long-established, mature firms."

Current Regime

The employee stock option tax regime in the *Income Tax Act* (Canada) generally provides for an employment income inclusion related to employee stock options equal to the amount by which (a) the fair market value of the shares received on the exercise of the options, exceeds (b) the exercise price paid by the employee (plus any amount paid by the employee to acquire the options).

Provided certain conditions are met, an employee may be eligible to claim a deduction equal to 50% of the income inclusion, which effectively results in the benefit being taxed at a rate equal to one half of the normal rate of personal taxation (i.e., the same rate as capital gains).

Proposals

Under the proposals, an employee at a "large, long-established, mature firm" will not be entitled to the preferential deduction discussed above with respect to the employment benefit arising in connection with employee stock options to the extent that the benefit relates to options that (i) are granted after the release of pending legislative proposals, and (ii) exceed a $200,000 annual cap on option grants (based on the fair market value of the underlying shares at the time that the options are granted).

As an example, suppose an employee of a "large, long-established, mature firm" is granted stock options to acquire 100,000 shares at a price of $40 per share, which was the fair market value of the shares on the option grant date. Under the current regime, assuming the conditions for the preferential deduction were otherwise met, the employee could claim the deduction with respect to the full amount of the income inclusion arising in connection with the options.

However, under the proposals, the $200,000 cap operates such that the employee will only be able to claim the deduction with respect to the income inclusion arising in connection with 5,000 ($200,000 cap divided by $40 fair market value per share) of the options. If, for example, the fair market value of the shares rose from $40 to $50 per share at the time the options were exercised, then the employee would only be entitled to a deduction of $25,000 (i.e., 5,000 options multiplied by the $10 increase multiplied by 50%). Under the current regime, the employee would be entitled to a deduction of $500,000.

Impact on Employers

While the proposals primarily impact employees, employers that are "large, long-established, mature firms" need to understand the impact of the proposals on their employees (discussed below) for purposes of negotiating and structuring long-term and executive compensation arrangements.

At an operational level, such employers will also need to track the entitlement to the stock option benefit deduction for each of its employee optionholders in order to comply with their source deduction obligations.

Further, where an employer acquires employee stock options for cash consideration (at the election of the employee), there may now be more opportunities for the employer to claim a deduction for such cash payment without adverse consequences to its employees. Currently, employers will routinely make a tax election and forego the right to deduct the cash payment as a precondition to the employee claiming the stock option benefit deduction. Employers should review their stock option plans to ensure that there is sufficient flexibility to allow them to not make the election in appropriate circumstances.

Impact on Employees

Given the annual cap and that the proposals are limited to options issued by "large, long-established, mature firms", many employees will not be affected by these proposals. However, for employees who will be affected, the impact of the proposed changes can be significant (as evidenced with the example above).

Once the rules are effective, employees who might otherwise be subject to the cap may want to consider deferring a portion of an option grant to a later taxation year. Of course, there will be other considerations at play, including that the employee will lose any appreciation in the value of the shares during the deferral period (assuming, in each case, that the exercise price will equal the fair market value of the shares on the date of grant). Additionally, consideration would have to be given to any loss of certainty of receiving any deferred option grant.

It is important to underscore that, as proposed, the cap relates to the date that the options are granted independent of when the options vest. In the example above, the employee will only be able to claim the deduction with respect to the income inclusion arising in connection with 5,000 of the options, even if the options vested over a period of many years.

No draft legislation concerning the limitation on employee stock option deductions has been released. Further, no guidance has been provided as to, among other things, what constitutes a "large, long-established, mature firm" or if there will be "ordering" rules (e.g., where the income inclusion associated with options issued on a particular grant date falls across multiple taxation years, will employees be able to choose which options are entitled to the deduction, and therefore, in which years to claim the deduction?).

Budget 2019 indicated that "any changes would apply on a go-forward basis only and would not apply to employee stock options granted prior to the announcement of legislative proposals to implement any new regime" and that further details will be released before this coming summer. Therefore, individuals who may be impacted by these proposals should consider (re)negotiating their compensation package and having options granted prior to the release of the legislative proposals.

For more information on the topic discussed in this update, please contact the authors of this article.

For more information or inquiries:

Ryan Morris

Toronto
416.947.5001

Email:
rmorris@weirfoulds.com

Ryan Morris is a tax partner and Chair of the firm's Tax Group. His legal practice focuses on various areas of domestic and international taxation, including advising on mergers and acquisitions, structured investment products, financings, estate plans, employment tax issues and a broad range of corporate tax matters. Ryan also represents clients with voluntary disclosures, audits and appeals, and he has been lead counsel at every level of court, including the Supreme Court of Canada.

WeirFoulds LLP

www.weirfoulds.com

Toronto Office
4100 – 66 Wellington Street West
PO Box 35, TD Bank Tower
Toronto, ON M5K 1B7

Tel: 416.365.1110
Fax: 416.365.1876

Oakville Office
1320 Cornwall Rd., Suite 201
Oakville, ON L6J 7W5

Tel: 416.365.1110
Fax: 905.829.2035