OSLER

Jun 21, 2019

Canadian government introduces tax legislation applying to employee stock options granted on or after January 1, 2020

Author(s): Hemant Tilak, Dov Begun, Lynne Lacoursière, Colena Der, Alain Fournier

EXECUTIVE SUMMARY

- On June 17, 2019, the Canadian government tabled a Notice of Ways and Means Motion with proposed amendments to the *Income Tax Act* (Canada) to implement the employee stock option proposals from the 2019 Federal Budget (Budget 2019).
- The proposals will apply to employee stock options granted by corporations and mutual fund trusts on or after January 1, 2020 (after the next federal election). The tax treatment of options granted before 2020 is unaffected.
- Generally, for employee stock options granted after 2019,
  - in the case of options granted by employers that are Canadian-controlled private corporations (CCPCs) or other non-CCPC corporations that are "start-ups, emerging or scale-up companies" (which will be defined by regulation after a stakeholder consultation period ending September 16, 2019), the options will be subject to the current tax regime (we refer to them as "qualified options") – employees will be entitled to deductions in respect of the option benefits (equal to one-half of the tax benefits realized on the exercise of certain stock options);
  - in the case of options granted by other corporations and mutual fund trusts, the options will be subject to the current tax regime (that is, they will be "qualified options") unless they exceed the $200,000 annual cap (described below) or the employer designates them, at the time of the grant, as being options that are subject to the new tax regime (we refer to them as "non-qualified options") – employees will not be entitled to deductions in respect of the option benefits; and
  - an employer deduction may be available for the option benefits realized by employees but only in respect of non-qualified options, subject to certain conditions being met (described below).

BACKGROUND

Under the *Income Tax Act* (Canada), when an employee exercises an employee stock option and acquires shares, the employee realizes a taxable employment benefit equal to the excess of the value of the shares at the time of acquisition over the exercise price paid for the shares. If the exercise price of the option is fixed at an amount that is not less than the fair market value of the share at the time the option was granted, and provided certain other conditions are met, the employee may be entitled to claim a deduction equal to one-half of the taxable benefit (the Employee Deduction). It is this deduction that allows stock option benefits to be taxed at the same tax rate applicable to capital gains.

Budget 2019 proposed an annual cap of $200,000 on stock option grants that would be eligible for the Employee Deduction. This proposal targeted stock options issued by "large, long-established, mature firms" while stock options issued by "start-ups and rapidly growing Canadian businesses" were excluded. The government also suggested, without any details, that the employer may be allowed a deduction for the option benefit on non-eligible options. Additional detail can be found in our earlier Osler Update.

THE PROPOSED AMENDMENTS

In general terms, the proposed amendments create two types of employee stock options:

- One type (which we refer to as the "qualified options") will be subject to the current tax regime.
- The other type (which we refer to as the "non-qualified options") will be subject to a new tax regime.

QUALIFIED OPTIONS

Qualified options will be subject to the current tax regime. That is, the employee may be entitled to the Employee Deduction, and the employer is not entitled to any tax deduction for the option benefits realized by the employee.

OPTIONS GRANTED BY CCPCS AND "START-UPS, EMERGING OR SCALE-UP COMPANIES"

All employee stock options granted by employers that are Canadian-controlled private corporations (CCPCs) or other non-CCPC corporations that are "start-ups, emerging or scale-up companies" will be qualified options. The characteristics of "start-ups, emerging or scale-up companies" will be defined by regulation after a stakeholder consultation period ending September 16, 2019.

These proposed amendments recognize the importance of employee stock options as a form of tax-preferred compensation for "younger and growing Canadian businesses" in attracting and retaining employees.

OPTIONS GRANTED BY OTHER CORPORATIONS AND MUTUAL FUND TRUSTS

Employee stock options granted by other corporations and mutual fund trusts may also be qualified options, but only if they are within a $200,000 annual cap and the employer does not designate them as being "non-qualified options" (described below).

This cap reflects the government's view that executives of large, mature companies should not be compensated using this form of tax-preferred compensation.

NON-QUALIFIED OPTIONS

Non-qualified options will be subject to a new tax regime. That is, the employee will not be entitled to the Employee Deduction but, subject to certain conditions, the employer may be entitled to a tax deduction for the option benefits realized by the employee (the Employer Deduction).

Employee stock options granted by mutual fund trusts and by corporations that are neither CCPCs nor "start-ups, emerging or scale-up companies" will be non-qualified options if the options are not qualified options only because the options are not within the $200,000 annual cap.

However, such employers may choose to designate, at the time of the grant, employee stock options that would otherwise be qualified options as being "non-qualified options" – that is, options that will be subject to the new tax regime. This is similar to the rules under the *United States Internal Revenue Code*, which permit an employer to designate options as being non-qualified stock options if they would otherwise qualify for the preferential tax treatment afforded to incentive stock options.

Employers who are CCPCs or "start-ups, emerging or scale-up companies" will not be able to designate options that would otherwise be qualified options as being "non-qualified options." Accordingly, such employers will not have the ability to claim an Employer Deduction (described below).

OTHER OPTIONS AND SHARE-SETTLED EMPLOYMENT COMPENSATION

The proposed amendments do not affect the taxation of options granted before 2020.

Nor do they affect the taxation of options and other share-settled employment compensation (such as restricted share units, performance share units, deferred share units, share appreciation rights and restricted share awards) that are not eligible under the current tax regime for the Employee Deduction.

THE $200,000 ANNUAL CAP

The cap will not apply in respect of qualified options granted by employers that are CCPCs or other non-CCPC corporations that are "start-ups, emerging or scale-up companies."

The cap will apply to qualified options issued by other corporations and mutual fund trusts that become vested in the same calendar year to the extent that the fair market value of the optioned shares under those options at the time of their grant is more than $200,000. This is similar to the $100,000 annual cap that applies to incentive stock options under the *United States Internal Revenue Code*.

The cap will apply separately for qualified options granted by employers that deal at arm's length with each other.

EXAMPLE

- The first example included in the Backgrounder accompanying the proposed amendments involves an executive that is granted options in 2020 to acquire 200,000 shares at a price of $50 per share (the fair market value of a share on the date the options are granted), with ¼ vesting in each of 2021, 2022, 2023 and 2024. In each vesting year, the value of the tranche of options that is expected to vest is measured to determine whether the $200,000 annual cap in that year is exceeded. In this example, 50,000 options are expected to vest in each of 2021 to 2024. Based on the fair market value at the time of grant of $50, the annual cap is exceeded in each of 2021 to 2024. As a result, the preferential treatment is only available to 4,000 of the options vesting each year ($200,000 ÷ $50) and the remaining 46,000 options per year would not be eligible for the Employee Deduction.

ORDERING AND OTHER SUPPORTING RULES

Ordering rules provide that, if an employee holds both qualified options and non-qualified options that are otherwise identical, the qualified options will be deemed to have been exercised first.

Options granted at different times will "fill" the $200,000 annual cap for the calendar year of vesting in the order in which they were granted. That is, options that vest in the same calendar year as qualified options previously granted will be non-qualified options if the previously granted options have "filled" the $200,000 annual cap for that calendar year.

The proposed amendments provide that, if the option grant agreement specifies the calendar year when an option becomes exercisable, then the option will be regarded as becoming vested in the year specified even if the option could become vested prior to the year specified as a consequence of an event that is not reasonably foreseeable at the time of the grant. In any other case, the option will be treated as becoming vested in the first calendar year in which the option can reasonably be expected to be exercised. This definition could create considerable uncertainty for options that have performance-based vesting conditions (such as achieving specified performance or rate of return metrics or completing a liquidity event).

EMPLOYER DEDUCTION

The *Income Tax Act* (Canada) includes a longstanding prohibition on an employer deduction for the option benefit realized by an employee. However, Budget 2019 indicated that this might change if option benefits are fully taxable and the Employee Deduction is not available.

The proposed Employer Deduction represents a significant change in tax policy but is narrower than we had hoped it would be. The proposed amendments provide for an Employer Deduction in the year an employee realizes the option benefit on options that are non-qualified options because the employer has designated the options as being non-qualified options or because the options are not within the $200,000 annual cap.

The Employer Deduction is equal to the option benefit realized by the employee. The deduction is subject to certain conditions, including:

- the employee would have been entitled to the Employee Deduction if the options were not non-qualified options;
- the employer has notified the Minister of National Revenue, in prescribed form in its tax return for the taxation year in which the options are granted, that the options are non-qualified options; and
- the employer has given written notice to the employee at the time the options were granted that the options are non-qualified options.

As now proposed, the Employer Deduction would not be available where – as is very often the case – the non-qualified options are granted by a parent corporation to employees of a subsidiary. It is unclear whether that was intended.

If the Employer Deduction results in a loss to the employer, the loss would be treated as a non-capital loss to the employer. This provides certainty that the Employer Deduction is not subject to a further determination as to whether the expenditure was incurred on income or capital account – a welcome clarification given the uncertainty arising from several court cases dealing with the tax treatment of option cancellation payments made by employers.

EMPLOYER REPORTING AND DESIGNATION REQUIREMENTS

Employers, other than CCPCs and "start-ups, emerging or scale-up companies," will be required to notify the employees in writing at the time of grant of options that would otherwise be qualified options if the options are non-qualified options because the employer has designated the options as being non-qualified options or because the options are not within the $200,000 annual cap.

The employer will also be required to notify the Minister of National Revenue, in prescribed form in the employer's tax return for the taxation year in which the options are granted, that the options are non-qualified options.

It may be difficult to comply with the notice obligations in the case of options which vest otherwise than in specified calendar years.

DELAYED IMPLEMENTATION UNTIL 2020

The proposed amendments will only apply to options granted on or after January 1, 2020 (after the next federal election). Delaying the implementation of the proposed amendments allows the government additional time to respond to the feedback received through the consultation before finalizing the amendments.

CONTACT US

For more information, please visit osler.com or contact the following individual(s):

MONTRÉAL
Alain Fournier, Partner, Taxation
514.904.5390
afournier@osler.com

TORONTO
Dov Begun, Partner, Taxation
416.862.6571
dbegun@osler.com

TORONTO
Hemant Tilak, Partner, Taxation
416.862.6400
htilak@osler.com

CALGARY
Colena Der, Partner, Taxation
403.260.7049
cder@osler.com

TORONTO
Lynne Lacoursière, Partner, Corporate
416.862.4719
llacoursiere@osler.com