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Global Reward Update
Canada

Proposed changes to capital gains and stock option inclusion rate

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Headline

Deputy Prime Minister and Minister of Finance, the Honourable Chrystia Freeland, presented the 2024 federal budget[1] in the House of Commons on 16 April 2024.

Currently, Canadians pay taxes on 50% of capital gains, which is generally the profit made when an asset, such as stocks, is sold. In Budget 2024, the government proposes to increase the capital gains inclusion rate from 50% to 66.67% on capital gains in excess of $250,000 realised, on an annual basis, by individuals on or after 25 June 2024.

The inclusion rate for capital gains realised by individuals up to $250,000 will remain at 50% and the government will maintain the current exemption for a capital gain on the sale of a principal residence.

Background

Although taxed as employment income, employees also currently benefit from a 50% deduction on benefits realised from the exercise of qualifying stock options. Budget 2024 also proposes to reduce this deduction. Claimants of the employee stock option deduction would be subject to a 33.33% deduction on the taxable benefit to reflect the new capital gains inclusion rate, but would be entitled to a 50% deduction on the taxable benefit up to a combined limit of $250,000 for both employee stock options and capital gains in a given year. This measure would also be effective on or after 25 June 2024.

The government has not released the amendments to the Income Tax Act[2] and has indicated that additional design details would be made public in the coming months.

On 18 April 2024, the Ministère des Finances du Québec announced[3] its intention to amend Québec's tax legislation to incorporate, with adaptations, measures relating to, among others, the increase to the capital gains inclusion rate and consequential measures, with the exception of the stock option deduction, which will be the subject of a subsequent announcement to take into account Québec's tax framework in this regard.

This alert outlines the potential impacts of these proposed changes on both employees and employers to help better understand the implications and prepare for them. Additional considerations for individuals and corporations can be found in the Canadian Tax and Legal Alert[4] published on 17 April 2024, including provisions related to the lifetime capital gains exemption.

What has changed

The changes to the capital gains inclusion rate proposed in Budget 2024 may create significant challenges for employers and employees alike. Although there is limited information available at this time, some of the complexities relate to the interaction between capital gains and stock options for purposes of calculating the $250,000 annual limit. There are also additional considerations for mobile employees, such as departure tax.

The impact of the proposed changes to the capital gains inclusion rate is such that, for example, an individual with capital gains of $250,000 in a given year would be subject to additional tax at a rate of approximately 8% or 9%[5] on any incremental capital gain (or stock option benefit) as a result of the changes.

Employer payroll considerations for stock options

Tracking of employee stock option benefits will be more complex going forward. Employers will need to have a robust tracking mechanism in place to ensure compliance with the applicable payroll withholding obligations and related payroll reporting. This adds an additional layer of complexity to the already detailed tracking required as a result of the 2021 changes to stock options taxation, which introduced the determination of qualifying versus non-qualifying stock options.[6]

At this time, it remains uncertain how employers should apply these rules to comply with their payroll withholding obligations on stock options benefits realised by their employees, given the $250,000 annual combined limit with capital gains. Will employers be required to obtain certifications from employees confirming their eligibility for a higher stock option deduction? Alternatively, should employers withhold income tax at the higher rate (i.e., reflecting the one-third deduction) and allow employees to claim the increased deduction on their personal income tax returns, if available? It is worth noting that, absent legislation to the contrary, some employers may choose to apply the higher inclusion rate to all stock option exercises as a means of simplifying their compliance burden.

Employees who exercise stock options and participate in a sell-to-cover programme with their employer to fund the income tax withholdings may face a challenge due to this uncertainty. It could result in a potential overselling of shares if the employer withholds at the higher inclusion rate for all options.

The budget documents state that the $250,000 annual limit will not be prorated for 2024. However, it remains unclear whether non-residents of Canada will be eligible for this full limit for 2024 (or in subsequent years), when exercising options that relate to work performed both inside and outside of Canada – i.e., would the $250,000 limit apply with respect to the entire stock option benefits or only to the Canadian-sourced portion?

Given this increased complexity, communication with employees will be critical to maintaining the attractiveness of such incentive programmes.

Canadian-controlled private corporations (CCPC) options

While it is acknowledged that the new rules will apply to the benefit realised from the exercise of stock options on or after 25 June 2024, the impact of the increased stock option inclusion rate on CCPC options remains uncertain, due to the fact that the benefit is only taxable at the time of the sale of the underlying shares. Some unanswered questions include how these rules will apply to:

- Stock options exercised prior to 25 June 2024, and where the shares are sold on or after such date;
- Stock options exercised prior to 25 June 2024, and where a qualifying exchange of shares occurs under subsection 7(1.5) of the Act on or after 25 June 2024; and
- All CCPC options where the $250,000 annual limit has been reached (e.g., will there be specific exemptions for CCPC options?).

Departure tax

The increase in the capital gains inclusion rate will impact individuals who cease to be Canadian tax residents on or after 25 June 2024. Capital gains from the deemed disposition of property (generally referred to as "deemed dispositions" or "departure tax") would be subject to the higher inclusion rate above the $250,000 annual limit.

Individuals planning to cease Canadian residency may wish to consider realising gains on certain assets or accelerating the date of departure from Canada in order to reduce the increased departure tax liability that may arise after 24 June 2024.

The draft legislation will need to be reviewed to determine if there are any changes to the current $50,000 limit on taxable income from deemed dispositions for which security is deemed to have been posted pursuant to subsection 220(4.51) of the Act.

Individuals who have previously ceased to be Canadian residents and who intend to return to Canada in 2024 (or later) may need to consider the potential impact of the change to the capital gains inclusion rate on any unwinding election if they have previously deferred Canadian departure tax and still own the underlying assets upon their return to Canada.

Tax considerations for mobile employees

Employers that have tax reimbursement policies (tax equalisation, tax protection, etc.) in place for their mobile employees will need to review them to assess the impact of the proposed changes and determine whether any revisions are warranted. Given the combined limit for lower taxation on capital gains and employee stock options, it will be crucial for employers to clarify how the $250,000 annual limit will be allocated under the tax reimbursement policy, particularly in situations where the employer's policy covers only one of these items – for example, under an existing policy, an employer may tax equalise on stock option benefits and not capital gains from the disposition of personal assets. Clear communication regarding this allocation will be important. If a tax reimbursement policy covers such items, the cost to the employer may increase as a result.

The proposed changes outlined above have the potential to increase the cost to employees who choose to relocate outside of Canada (i.e., increased departure tax) or make it more challenging to attract or retain employees in Canada (i.e., less favourable taxation of capital gains and stock options). As a result, employers may need to review and adjust their mobility policies accordingly.

Deloitte's view

Until the legislation implementing these changes is released, it will not be possible to provide complete answers to all of the questions raised. However, it is important to consider the actions that individuals may wish to take in response to these proposed changes. For example, some individuals may decide to expedite a planned departure from Canada, while others – with significant unrealised capital gains – may wish to trigger gains on appreciated property prior to 25 June 2024. Additionally, subject to any programme restrictions, employees may decide to accelerate the exercise of vested stock options with accrued benefits. Individuals planning to return to Canada should assess whether it is advisable to unwind any outstanding departure tax that will be due upon their return to Canada. Individuals should review their asset portfolios, including real property owned, to evaluate the potential impact of relocation and available tax elections.

The changes to the stock option inclusion rates will introduce further complexities to the employers' existing responsibilities regarding payroll withholding and reporting obligations. The changes to the stock option taxation rules in 2021 already limited the employee stock option deduction for non-qualifying options. With the additional limitations now being imposed, clear and timely communication with employees will be key to maintaining the attractiveness of this form of compensation. Pending a review of the supporting legislation, employers may wish to consider applying payroll withholdings based on the reduced stock option deduction to streamline their processes to some extent. More broadly, given the added complexity and somewhat reduced benefit to employees, employers may want to reassess the use of stock options as part of their overall executive compensation packages.

Who to contact

If you would like to discuss this further, or have any questions, please speak to your usual Deloitte contact or any of the contacts listed below:

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[1] Canada, Department of Finance, 2024 Budget, Budget Plan, April 16, 2024.
[2] RSC 1985, c. 1 (5th Supp.), as amended, herein referred to as "the Act."
[3] Finances Québec, Information Bulletin 24-5, "Harmonization with certain tax measures proposed in the federal budget of April 16, 2024," released on April 18, 2024.
[4] Deloitte, Canadian Tax & Legal Alert, "2024 federal budget highlights," April 17, 2024.
[5] This will vary based on marginal rates and applicable province. For Quebec tax purposes, this difference will vary depending on whether the proposed changes will be implemented in Quebec as they were introduced for federal tax purposes.
[6] Deloitte, Canadian Tax & Legal Alert, "Canadian Federal Economic Update – Employee stock options," February 15, 2021.

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