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Global Reward Update

Canadian Federal Economic Update – Employee Stock Options
March 2021

Background

In June 2019, the Canadian federal government proposed changes that would limit the availability of the 50% employee stock option deduction for high-income individuals employed by large, mature, and established corporations, while preserving the deduction for employees of start up and emerging corporations.

On 30 November 2020, based on the June 2019 announcement and further to comments received from stakeholders, the government announced that it will move forward with the proposed $200,000 annual limit on option grants that may qualify for the employee stock option deduction. Under the proposed rules, employers will be responsible for tracking this limit and notifying both the employee and the Canada Revenue Agency (CRA) within 30 days of the date of grant as to whether options granted are eligible for the stock option deduction.

The proposed rules will apply to stock options granted on or after 1 July 2021.

Employers that are Canadian controlled private corporations (CCPCs) or are considered "smaller employers" (i.e. generally those with annual gross revenues of $500 million or less, determined at the highest level of consolidation for employers in a corporate group) are excluded from the changes.

Calculating the $200,000 limit

The $200,000 limit applies on an individual basis, and for each calendar year in which options vest and first become exercisable. It must be calculated on the fair market value of the underlying shares at the time of grant.

If it is unclear on grant when the options will vest, the options will be treated as vesting on a pro-rata basis over the term of the agreement, up to a maximum of five years (e.g., for options exercisable on a liquidity event).

Exceeding the limit and corporate tax deduction considerations

An employer subject to the new rules could choose to grant stock options either:

01. under the existing tax treatment (i.e., options qualifying for the 50% deduction, subject to the $200,000 limit for each employee, with no corporate tax deduction); or
02. under the new treatment (i.e., non-qualifying options where employees are ineligible for the 50% stock option deduction; however the employer would be able to take a corporate tax deduction in the year of exercise).

The corporate tax deduction is only available if the stock options satisfy all other conditions in Canadian tax legislation to qualify for the 50% deduction, regardless of the $200,000 limit. An employer may be eligible for this deduction even where the options were granted over foreign parent company stock. An employer not subject to the new rules is not able to opt into the new rules in order to claim a corporate tax deduction.

For a given year, where the value of vested options exceeds $200,000, the earliest granted options will qualify for the stock option deduction. If the employee has a number of identical stock options where some qualify for the existing treatment and others will be subject to the new rules, the stock options qualifying for the existing treatment will be treated as having been exercised first.

Key questions and considerations

Compensation strategy
Although many employers have recently revisited their compensation strategy and framework for executives (often limiting the amount of stock options granted, replacing them with other types of incentives), it is worth considering the following points:

- whether stock options grants can be accelerated prior to July 2021 in order to preserve the existing stock option treatment;
- what is the value of the after-tax amount received, in order to determine the total compensation offered through stock options, and consider whether other types of incentive awards should be used instead;
- what the employee communication strategy should be; and
- how to design an administrative process to 1) comply with employee and CRA notification requirements for options ineligible for the stock option deduction, and 2) track the stock options which are eligible versus non-eligible for the deduction.

$500 million revenue threshold
Employers who are currently excluded from these rules as they are "smaller employers" should consider when they might meet this threshold when determining their future equity compensation awards. It will be key for finance and HR teams to communicate regularly given each option grant must be quickly identified as qualifying or not.

Cross-border employees and employers
Multinationals with Canadian-based employees (or with executives who travel to Canada) should consider the tax impact of the new rules on their overall compensation package, including recalculating assignment cost estimates for tax gross-ups. Tax equalisation policies should also be reviewed and consideration given to whether a change to the policy is required, given the potential additional costs for the employee and/or the employer.

It remains uncertain how the $200,000 annual limit will be applied for internationally mobile employees who are not resident of Canada for the entire period between grant and exercise.

Where the stock options do not qualify for the stock option deduction, a corporate tax deduction is only available where the employee pays tax in Canada on the income received on exercise of the options. Where an employee is non-resident at the time of exercise, the corporate tax deduction will be limited to the amount of income that is ultimately taxable in Canada.

Where a foreign parent corporation grants stock options to an employee of a Canadian subsidiary, consideration should be given as to the entity that should claim the corporate tax deduction arising on those stock options. An intercompany recharge agreement may be required for the Canadian employing company to bear the cost of the stock options and claim the corporate tax deduction.

Non-qualifying options
The draft legislation allows an employer to grant employee stock options under the existing treatment up to the $200,000 limit on a per employee basis. This may mean that options granted to one employee qualify for the stock option deduction, while options granted to another employee do not. Companies will want to consider the following issues:

- Can the approach taken change each time options are granted?
- Once the determination has been made with respect to a particular stock option grant (whether qualifying or non-qualifying), can this determination be changed prior to vesting or exercise of the options?
- Is there a prescribed form on which the employer makes this election and if so, must it be filed with the CRA?
- Is there a prescribed form that the employer should use to notify the employee of the stock option determination and is there specific information that must be included?

Quebec
At the time of publication, the government of Quebec has not announced any measures similar to the federal rules limiting the availability of the stock option deduction for Quebec tax purposes. If this remains the case, there will be misalignment in the stock option treatment which would result in additional tracking and reporting complexities for employers with employees in the province of Quebec.

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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