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Canadian Tax & Legal Alert

Canadian Federal Economic Update – Employee Stock Options

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Background

In June 2019, the Canadian federal government proposed changes to the treatment of employee stock options to limit the availability of the 50% 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 November 30, 2020, based on the June 2019 announcement and further to comments received from stakeholders, the Deputy Prime Minister announced that the government will move forward with proposed changes to impose a $200,000 annual limit on option grants that may qualify for the stock option deduction. Under the proposed rules, employers would be responsible for tracking this limit for each employee and notifying both the employee and the Canada Revenue Agency (CRA) within 30 days of the date of grant as to whether the options granted are eligible for the stock option deduction.

The new proposed rules would apply to stock options granted on or after July 1, 2021. Furthermore, options granted prior to July 1, 2021, and exchanged for replacement options after such date, would not be subject to the new rules.

The new proposed rules would also not apply to options granted by Canadian-controlled private corporations (CCPCs) or by smaller employers (defined below).[1]

Defining "smaller employers"

The new proposed rules would apply to employers that are corporations or mutual fund trusts and exclude employers that are CCPCs or are considered "smaller employers".

A "smaller employer" is defined as an employer with annual gross revenues of $500 million or less. "Gross revenues" for these purposes pertain to the gross revenues reported in the most recent annual financial statements presented to shareholders (or unitholders) before the date of the stock option grant, and in accordance with generally accepted accounting principles.

Where an employer is a member of a corporate group, the gross revenues would be determined at the highest level of consolidation in the most recent consolidated annual financial statements of the group presented to the shareholders (or unitholders).

Calculating the $200,000 limit

The $200,000 limit would be applied on an individual employee basis, reflecting the fair market value of the underlying shares at the time of grant. The limit would apply for each calendar year when the options vest ("vesting" is considered to occur when the options first become exercisable).

The determination of when the options vest is made at the time of grant. If it is unclear at the time of grant when the options vest, the options would be considered to vest on a pro-rata basis over the term of the agreement, for a maximum of five years (e.g., in the context of options exercisable only upon a liquidity event).

For entities subject to the new rules, the $200,000 limit would apply to all stock option agreements made between an employee and the employer (or any corporation not dealing at arm's length with the employer). If the individual has two or more employers dealing at arm's length with each other, a separate $200,000 limit would apply for each employer.

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[1] This publication is based on legislative proposals and commentary available as of February 4, 2021 and is effective on that date.

Exceeding the limit and corporate tax deduction considerations

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

(1) 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
(2) under the new treatment (i.e., non-qualifying options, for which employees are ineligible for the stock option deduction with a corporate tax deduction in the year of exercise).

The corporate tax deduction would only be available if the stock options otherwise satisfied the general conditions to qualify for the 50% deduction under subparagraph 110(1)(d) of the Income Tax Act (with such determination being made for each particular grant), regardless of the $200,00 limit. It is worth noting that an employer not subject to the new rules could not opt in to the new rules to claim a corporate tax deduction. An employer may be eligible for this deduction even where the options were granted on a foreign parent company stock.

For a given year, where the vested options exceed $200,000 (based on the fair market value of the underlying shares at the time of grant), the earliest granted options would be first to qualify for the stock option deduction. If the employee has a number of identical stock options where some qualify for the existing treatment while others would be subject to the new treatment, the stock options qualifying for the existing treatment would be considered to have been exercised first.

For example, where an employee has been granted the following stock options after July 1, 2021:

	Grant 1	**Grant 2**
Date	July 2021	October 2021
Number of options granted	50	50
Vesting schedule	100% vesting on first anniversary of grant date	100% vesting on first anniversary of grant date
Value of the shares at the time of grant	$150,000	$100,000

In 2022, the value of the vested stock options will be $250,000, based on the fair market value of the underlying shares at the time of grant. When the employee exercises his/her options, the 50 options first granted and exercised would qualify for the 110(1)(d) stock option deduction. Of the remaining 50 options, only 25 of the options would qualify for the 110(1)(d) stock option deduction, while the other 25 options would be taxable at the taxpayer’s marginal tax rate (without any preferential tax rate applied).

Charitable donations

Under the proposed rules, where an employee donates to a qualified donee publicly listed shares acquired pursuant to a stock option agreement within 30 days of the exercise, and such options are in excess of the $200,000 annual limit, the 50% charitable donation tax credit would remain available, but the 50% stock option deduction would not be available with respect to the non-qualifying options. Any capital gain on the donated shares that has accrued since the shares were acquired under the stock option agreement would continue to be eligible for the full capital gains exemption, subject to existing rules.

Key questions and considerations

While employers are considering the impact of the new stock option rules for their organization and employees, consideration should be given to the following elements in order to determine the approach that should be adopted, the discussions that should occur and the actions that should be taken:

Compensation strategy

Although many employers have been revisiting the compensation strategy and framework for executives in recent years (and often limiting the amount of stock options granted, replacing them with other types of incentives), the following should be contemplated.

- consider accelerating stock option grants prior to July 2021 (i.e., prior to the stock option changes coming into force) in order to preserve the existing stock option treatment;
- revisit the total level of compensation offered through stock options, assess the after-tax impact and consider exploring other equity-based compensation awards in collaboration with the company's remuneration committee and board of directors as applicable;
- consider a communication strategy to affected executives for stock option grants made after June 2021; although the initial June 2019 announcement indicated that the intent was to limit the stock option deduction for high-income individuals, the current draft legislation does not distinguish by individual income level; and
- design an administrative process to 1) fulfill the 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 stock option deduction.

$500 million revenue threshold

Employers who may currently be excluded under the $500 million revenue test should consider the likelihood of this threshold being met in the future and determine what their future equity compensation awards may look like. It will be key for the finance and HR teams (and in the case of employees of a subsidiary, at the parent company level where options are granted by such entity) to communicate regularly on this matter given each option grant will need to be quickly identified as qualifying or not. This analysis should be based on the employer's most recent annual financial statements, reflecting any adjustments to the revenue calculations required to determine whether the $500 million threshold has been met, based on generally accepted accounting principles.

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 equalization 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 would be calculated for employees in a cross-border situation (e.g., for non-resident employees with stock option income related to Canadian services, would the $200,000 limit apply only to the Canadian sourced portion of the award?). How would the $200,000 limit operate in the context of an employee who was granted stock options prior to arriving in Canada, where the options vested prior to establishing Canadian residency, but were exercised when the employee was a resident of Canada?

It is important to note that the obligation to notify the employee and the CRA about the qualification of stock options granted for the stock option deduction lies with the employer and not with the grantor of the options. In other words, even though a parent company may grant stock options to a subsidiary's employees, the actual employer would be responsible for notifying the employee and CRA accordingly.

Where the stock options do not qualify for the stock option deduction, the corporate tax deduction for the cost of the options exercised would only be available if the income is taxable to the employee in Canada. In the case of an employee who is a non-resident of Canada at the time of exercise, the corporate tax deduction would therefore be limited to the amount of income that is ultimately taxable in Canada.

Additionally, the corporate tax deduction is available only to the extent that it has not been claimed by another corporation. In this regard, in the case of a foreign parent corporation granting stock options to an employee of a Canadian subsidiary, it would need to be determined which entity should claim the corporate tax deduction with respect to the stock option benefit. An intercompany recharge agreement may be required for the Canadian entity to bear the cost of the stock options and claim the corporate tax deduction. In any case, only an employer of the employee could claim this deduction.

Non-qualifying options

The draft legislation seems to indicate that an employer may choose to grant employee stock options under the existing treatment (i.e., eligible for the stock option deduction), up to the $200,000 limit on an employee-by-employee basis. In other words, options granted to one employee may qualify for the stock option deduction, while options granted to another employee may not. The following questions remain with respect to such a determination:

- Can the approach taken change year-to-year, or more frequently, at any 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 subsequently changed prior to the vesting or exercise of the options? Or is this determination irrevocable?
- Is there a prescribed form on which the employer makes this election? Must the election 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 in the employee notification?

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.

How can Deloitte help you?

If you have any questions on any of the above, please reach out to your Deloitte representative or any of the individuals noted on this alert.

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