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Will Tax Treatment for Canadian Stock Options Change?

The newly elected Liberal government indicated in its election platform that it intends to increase taxes on employee stock option benefits by limiting Canadian resident employees from claiming the stock option deduction (*i.e.*, the capital gains equivalent taxation) in respect of option benefits in excess of \$100,000 annually.

The platform estimated that the stock option deduction cost the Canadian government \$750 million in 2014. However, this fails to account for the fact that employers generally forgo a tax deduction where employees are entitled to the stock option deduction. It is hoped that the new government will carefully re-evaluate the proposal having regard to the overall impact of implementing any limitation to the stock option deduction, and that it will also consider the significant value it provides employers in incentivizing their Canadian employees.

However, in the meantime, we are in a period of significant uncertainty because it is unclear what changes, if any, the government will enact and, if the government proceeds with implementing a limitation on the stock option deduction, whether there will be any grandfathering for existing options.

The Stock Option Deduction

Upon exercising a stock option to acquire a share, a Canadian resident employee has an employment benefit equal to the difference between the fair market value of the share and the option exercise price. (In the case of a stock option issued by a Canadian-controlled private corporation, the taxation of the employment benefit is deferred until the underlying share is sold.) Where the stock option is cashed out, the employment benefit is equal to the cash payment received.

Where certain conditions are satisfied, the Canadian employee is entitled to deduct one-half¹ of the employment benefit (*i.e.*, the stock option deduction) in computing his or her taxable income so that the employee is taxed on an equivalent basis to capital gains. Stock options issued to Canadian resident employees are typically structured to meet the conditions that entitle employees to the stock option deduction.

Treatment to the Employer

Canadian employers are not entitled to a deduction for tax purposes in respect of the shares issued on the exercise of stock options. In addition, as a result of amendments in 2010,

¹ Generally one-quarter for Québec provincial tax purposes.

employees are only entitled to the stock option deduction on the cash-out of stock options where the employer files an election stating it will not deduct such payment for tax purposes.

An employer is thus generally forgoing a deduction by implementing a compensation plan that allows employees to claim the stock option deduction. Most employers consider this appropriate because stock options generally have no in-the-money value on the date of grant and provide no assurance that the employees will ever receive any benefit under the stock options. In addition, the employer can increase the potential economic upside to the employee, thereby creating greater alignment with the employer's goals. The stock option deduction also provides the employees with similar tax treatment to that of the equity holders of the employer.

Comments on the Proposed Limitation of the Stock Option Deduction

The Liberal platform stated:

A starting point would be to set a cap on how much can be claimed through the stock option deduction. The Department of Finance estimates that 8,000 very high-income Canadians deduct an average of \$400,000 from their taxable incomes via stock options. This represents three quarters of the fiscal impact of this deduction, which in total cost \$750 million in 2014. Stock options are a useful compensation tool for start-up companies, and we would ensure that employees with up to \$100,000 in annual stock option gains will be unaffected by any new cap.

Currently, employees generally have an incentive to defer exercising their vested options so that they do not trigger the employment benefit until there is an intention to sell the underlying shares and, in the case of an employer that is not a Canadian-controlled private corporation, an obligation to pay the tax in respect of such benefit. Moreover, where an employee does not intend to immediately dispose of the shares, the employee will have a capital loss if the shares subsequently devalue and the capital loss cannot be used to offset the employment benefit that was triggered on the exercise of the options. The proposal to implement an annual limitation of \$100,000 for claiming the stock option deduction may cause certain employees to exercise options earlier than they otherwise would have and dispose of the shares to fund the tax liability arising on the exercise and at the same time limit the risk of being taxed on a benefit that could subsequently be reduced. However, in many cases, employees will not have this option because of vesting limitations and, in the private company context, not having a market in which to sell the shares.

In addition, the increase in revenue to the government that the platform suggests would be achieved would likely be offset to some extent by employers restructuring their stock option plans to get a deduction for benefits provided to their employees. Because of this, one well-known Canadian economist estimates that limiting the stock option deduction will cost the Canadian government \$12 million annually instead of resulting in additional revenue.

What Should You Do?

At this time, it is unclear if and when the government may seek to limit the stock option deduction and, if it does, what the scope of any such limitation will be. If the government does proceed with any such measures, it is possible that they could become effective on the date they are announced. In addition, while we would hope there would be some grandfathering for existing stock options, it is uncertain whether this will be the case.

As a result, employees that are potentially affected by any such limitation should carefully weigh their alternatives (including having regard to the proposed increases in personal tax rates), and employers that are considering granting options may consider accelerating such grants in case any new proposal provides grandfathering for existing options.

If you have any questions regarding the foregoing, please contact [Ian Crosbie](mailto:ian.crosbie@dwpv.com) (416.367.6958), [Elie Roth](mailto:elie.roth@dwpv.com) (416.863.5587) and [Raj Juneja](mailto:raj.juneja@dwpv.com) (416.863.5508) in Toronto, and [Brian Bloom](mailto:brian.bloom@dwpv.com) (514.841.6505) in Montréal.

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