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Draft Legislation on the Taxation of Stock Options

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The federal government has released much anticipated draft legislation proposing changes to the rules relating to the taxation of stock options. The legislative proposals are expected to come into force on January 1, 2020, and to apply to option agreements entered into after 2019. The release, on June 17, 2019, is the next step in implementing the federal government's announcement in the 2019 budget that it would impose a $200,000 annual cap on the deductibility of employee stock option grants for employees of "large, long-established, mature firms." Uncertainty regarding which companies would be subject to these new limits has caused significant concern in the business and tax community.

The new draft legislation begins the process of clarifying which corporations are subject to these proposed limitations and introduces a new deduction for employers on the exercise of certain stock options.

Companies Subject to the New Proposals

The new limitations will not apply to options issued by Canadian controlled private corporations (CCPCs) and other corporations that meet "prescribed conditions," which have yet to be established. In the backgrounder to the proposed changes, the Ministry of Finance (Finance) notes that the prescribed-conditions exemption is intended to apply to "start-up, emerging, and scale-up companies." Finance is asking for submissions on the appropriate prescribed conditions, with the consultation period open until September 16, 2019. Although this week's release indicates some of the criteria that may be used to distinguish between large, long-established, mature firms and start-up, emerging, and scale-up companies, it is not yet clear which non-CCPC corporations will be exempted under the prescribed conditions.

Limitations on Deductions Available to Employees

Under the existing rules, when a stock option is exercised, the difference between the strike price and the fair market value of the option at the time it is exercised is included in the employee's income as a taxable benefit. Employees are able to access preferential personal income tax treatment on qualifying stock options by claiming an offsetting deduction equal to one-half of the benefit, under paragraph 110(1)(d) of the *Income Tax Act* (Canada).

The new legislative proposals deny the 50% deduction for options affected by the new rules that have the same "vesting year," regardless of the strike price of the option, to the extent that the fair market value of the securities under the options exceeds $200,000 at the time the options are granted. A vesting year in respect of an option agreement is either (i) the calendar year in which the employee is first able to exercise his or her option as specified in the option agreement or (ii) if the option agreement is silent on that point, the first calendar year in which the option can reasonably be expected to be exercised.

Under the legislative proposals, companies must notify the employees and the tax authorities of option grants that are subject to the new rules. As discussed below, employers can also designate options that would otherwise qualify for the 50% deduction as non-qualifying.

Deductions Available to Employers

Under new paragraph 110(1)(e), employers will be entitled to a deduction in computing their taxable income when options of non-qualifying securities are exercised. The amount of the deduction will be equal to the amount of the taxable benefit to the employee under subsection 7(1). The employer will be entitled to the deduction provided that (i) the employer notifies the employee and the tax authorities that the security in respect of the option is non-qualifying at the time the option is granted and (ii) an amount would have been deductible

by the employee under paragraph 110(1)(d) if the security were qualifying. Given that in the ordinary course it is accepted that cash-surrender payments for options are deductible to the issuer when the holder does not have the benefit of the paragraph 110(1)(d) deduction, it is unclear why this second requirement was included and, as a result, there may be a preference to settle options in cash in respect of non-qualifying securities to simplify reporting if the proposals take effect in their current form.

In order to clarify which securities are non-qualifying at the time the option is granted, the legislative proposals allow companies to designate securities in respect of new option grants as non-qualifying, provided that the company so specifies in the option agreement. If a company fails to make this designation in the option agreement, it will not be able to notify the employee at the time the option is granted that the security is non-qualifying, and the company will therefore not be entitled to the paragraph 110(1)(e) corporate deduction.

Remaining Uncertainties

Issues regarding the application of these rules are likely to come to light as they are considered further, and once the prescribed conditions are announced. For example, it is unclear how the new rules will apply when vesting is tied to a liquidity event, when there is an accelerated vesting of options on a change of control or when the options vest only on the occurrence of some other specified event.

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