STOCK OPTION PLANS AND WHAT'S NEXT?

CI GLOBAL ASSET MANAGEMENT

The Liberal federal government announced in their 2019 budget that they would limit access to deduction for high income earners. Later in fall 2020 the liberals also announced that they will pursue their proposal for stock options with some modifications. If enacted, the changes will be effective on July 1, 2021. In this article we will examine the actual rules and the proposed changes regarding the stock option plans.

A stock option plan is an arrangement where an employee is given an option to purchase a specified number of shares at a given price. Companies provide employee stock option (ESO) plans as part of the employee's compensation. Under an ESO plan, the employee is usually given the right to acquire shares at a future date for a fixed price. The price is usually fixed at the fair market value (FMV) of the shares when the stock option is given to the employee. Because the employee has the potential to participate in the future increase in the corporation's share value, the employee has an incentive to increase the value of the shares. Of course, the advantages to the employee are reduced if the incentive is given to pay a reduced salary. Generally, an expiry date is contained in the agreement that establishes the plan. The exercise dates may be staggered over several years so that the employee is required to remain with the corporation for a certain period before she is entitled to exercise some or all of the options.

The advantage for the employer is attaching the employee to the corporation, therefore stabilizing employee turnover, especially for key employees, and stabilizing the corporation's management, which will help ensure a growth in business and value of the shares.

If the exercise price is below the FMV (it's not always easy to determine the value for private corporations) the employee receives an immediate benefit without financially impacting the corporation. The employee can then participate in the growth potential of the corporation without draining the corporate cash.

HOW IS IT TAXED?

Section 7 of the Income Tax Act sets out the rules regarding the stock option plans. Paragraph 7(3)(a) deems that no benefit is recognized when the option is granted. Under paragraph 7(1)(a) a benefit is recognized when the option is exercised unless the employer is a Canadian controlled private corporation (CCPC) dealing at arm's length from the employee. In the case of a CCPC the benefit is recognized when the shares are disposed of under subsection 7(1.1). In both cases, an offsetting deduction of 50% of the benefit may be available under paragraph 110(1)(d) or 110(1)(d.1). The benefit is also added to the adjusted cost base of the shares under paragraph 53(1)(j) to avoid double taxation on the benefit.

Let's look at an example:

Stephanie is granted an option to acquire company shares on May 1, 2021 at a price at the FMV of $150 per share. She exercises the option on May 1, 2023 and acquires the shares, the FMV of the shares at that time is $200. Stephanie sells the company shares in 2025, the FMV at the time of disposition is $250.

SCENARIO 1: EMPLOYER IS A NON-CCPC OR A NON-ARM'S LENGTH CCPC

MAY 1, 2021
OPTION GRANTED
No benefit is taxable at this time

MAY 1, 2023
Employee exercises the option
Employment benefit: $200 - 150 = $50
Potential deduction = $25

MAY 1, 2025
Employee sells the shares
Capital gain: $250 - 200 = $50

SCENARIO 2: EMPLOYER IS AN ARM'S LENGTH CCPC

MAY 1, 2021
OPTION GRANTED
No benefit is taxable at this time

MAY 1, 2023
Employee exercises the option
No taxable benefit

MAY 1, 2025
Employee sells the shares
Employment benefit: $200 - 150 = $50
Capital gain: $250 - 200 = $50
Potential deduction = $25

Deduction under paragraphs 110(1)(d) and (d.1):

Paragraph 110(1)(d) allows an employee to deduct from her taxable income an amount that is equal to one half of the benefit that is realized on the exercise of certain stock options, which means that the employee will be subject to tax only 50% of the benefit. Although this deduction results in treatment that is similar to capital gains treatment (the income inclusion is 50 percent), the taxable benefit is included as employment income, and the capital gain exemption for qualified small business shares under section 110.6 cannot be claimed. Paragraph 110(1)(d) applies if:

Simply put, if the share is a prescribed share (plain common share with no retraction rights or no dividend restrictions), the value of the shares when the stock option was granted did not exceed the exercise price of the stock option, and the corporation was dealing at arm's length with the employee at that time, the deduction is available.

Deduction under paragraph 110(1)(d.1) applies for CCPC shares if the taxpayer is deemed to receive a benefit in respect of shares acquired by the taxpayer, he has not disposed of or exchanged the shares within two years after the acquisition, and he has not deducted any amount under paragraph d in respect of the shares. The shares do not have to be prescribed shares.

If a deduction is not available under 110(1)(d.1), it may still be available under 110(1)(d).

Non-residents

In the situation where an individual who is a Canadian resident is granted a stock option by virtue of his employment in Canada with the employer corporation, and then the individual ceases to be a resident of Canada, the following applies:

(a) Pursuant to subparagraph 128.1(4)(b)(vi), the individual is not deemed to have disposed of his or her rights under a stock option at the time the individual becomes a non-resident and therefore section 7 does not apply to any unexercised options at that time.

(b) As a non-resident, the individual is taxable in Canada under subsection 2(3) as determined under subparagraph 115(1)(a)(i) (income from employment) in respect of any benefit received when the stock option is exercised, because the employment for which the stock option was granted was performed in Canada.

With respect to (b) above, the non-resident individual may be entitled to relief from Canadian income taxation under a relevant tax convention between Canada and the individual's country of residence at the time the stock option is exercised. In addition, a non-resident filing a return under subsection 115(1) may be entitled to a deduction under paragraph 110(1)(d) or (d.1) in computing taxable income.[1]

[1] IT-113R4 Benefits to Employees – Stock Options

WHAT HAPPENS IF THE EMPLOYEE DIES?

Employee stock options may be cancelled on death as a term of a stock option contract; such a cancellation is not a taxable event. However, if exercise of the option continues to be possible for a period of time, paragraph 7(1)(e) deems the employee to have received an employment benefit in the year of death equal to the fair market value of unexercised stock options owned less the amount paid to acquire such options. The similar benefit in a pre-death situation is computed.

Provided that the requirements in paragraph 110(1)(d) are met, a taxpayer is entitled to a deduction of one-half of the employment benefit arising from employee stock options. Effectively, since only one-half of the benefit is taxed, the result is that the benefit is taxed at a rate similar to the one applied to capital gains, as opposed to being taxed at the same rate as employment income.[2]

WHAT'S NEXT? – PROPOSED TREATMENT

$200,000 Limit

For employee stock options granted by employers that are subject to the new rules, there will be a $200,000 limit on the amount of employee stock options that may vest in an employee in a year and continue to qualify for the stock option deduction. An option vests when it first becomes exercisable. The determination of when an option vests will be made at the time the option is granted. To determine the number of options that may vest in any calendar year, the value of those options will be the fair market value of the underlying shares when the options are granted.

The $200,000 limit on the amount of employee stock options that may vest in any calendar year will generally apply to all stock option agreements between the employee and the employer or any corporation that does not deal at arm's length with the employer. If an individual has two or more employers who deal at arm's length with each other, the individual will have a separate $200,000 limit for each of those employers.

If the amount of stock options that may vest in a year exceeds $200,000, those employee stock options granted first will be the first to qualify for the stock option deduction. Where an employee has several identical stock options and some qualify for the existing treatment while others are subject to the new rules, the employee will be considered to exercise the stock options qualifying for the existing treatment first.

Employers subject to the new rules will be able to choose whether to grant employee stock options subject to the current tax treatment, up to the $200,000 limit per employee, or whether to designate employee stock options that would otherwise be subject to the current tax treatment as being subject to the new rules.

The proposed changes will not apply to CCPCs, but will apply to all corporations (including non-Canadian controlled private corporations and public companies) and mutual trust funds if their annual gross revenues (on a consolidated basis, if applicable) exceed $500 million.

Employee tax treatment

Where an employee exercises an employee stock option that exceeds the $200,000 limit, the difference between the FMV of the share at the time the option is exercised and the amount paid by the employee to acquire the share will be treated as a taxable employment benefit. The full amount of the employment benefit will be included in the income of the employee for the year the option is exercised, consistent with the treatment of other forms of employment income. The employee will not be entitled to the stock option deduction in respect of this employment benefit.

Charitable donations

Under the current tax rules, if an employee donates a publicly listed share (or the cash proceeds from the sale of a publicly listed share) acquired under an employee stock option agreement within 30 days of the exercise of the option to a qualified donee, such as a registered charity, the employee is eligible for an additional deduction equal to one half of the employee stock option benefit. As a result, where both the stock option deduction and the additional deduction in respect of a qualifying donation are available, the entire employee stock option benefit is effectively excluded from income. Donations of shares of private corporations are not eligible for the additional deduction.

If an employee donates a publicly listed share acquired under a stock option that is subject to the new tax rules,

[2] Canadian Tax Focus Volume 5, Number 3, August 2015, CTF

the employee will not be eligible for a tax exemption on any associated employee stock option benefit. Any capital gain that has accrued since the share was acquired under the stock option agreement will continue to be eligible for the full exemption from capital gains tax, subject to existing rules.

Employer tax treatment

For employee stock options granted in excess of the $200,000 limit, the employer will be entitled to an income tax deduction in respect of the stock option benefit included in the employee's income. The deduction may be claimed in the taxation year that includes the day on which the employee exercised the stock option.

Employers subject to the new rules will be entitled to a deduction for income tax purposes where the employee would have been entitled to the stock option deduction had they been granted under the existing rules.

Generally, employers that are subject to the new rules will also be able to designate employee stock options as ineligible for the employee stock option deduction (and instead eligible for a deduction for corporate income tax purposes) under the terms of the stock option agreement.

Corporations that are not subject to the new rules will not be permitted to opt in to the new employee stock option tax rules[3].

For more detailed information or tax planning, please consult a tax advisor.

[3] Department of Finance Canada

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