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NEW legislative changes to employee stock options in Canada

Proposed changes to stock option benefit taxation and employer obligations from the 2024 federal Budget

Delays in implementation

Since the federal budget was tabled in April 2024, there has been considerable debate and speculation surrounding the enactment of the proposed increase in the capital gains inclusion rate and changes to the taxation of stock option benefits.

Considering the recent delays in enacting this legislation, we are providing below some points for employers to consider in applying the proposed changes to stock option transactions after June 24, 2024.

As a reminder, the budget proposals were initially introduced in a Notice of Ways and Means Motion in June 2024, and then again in September 2024 with amendments that incorporate revisions from the legislative proposals published in August 2024 and certain other minor technical changes. The proposed legislation needs to be tabled in a bill before the House of Commons and, once adopted, must also be tabled before and adopted by the Senate prior to receiving Royal Assent, and thus becoming law. This process can be delayed, in part due to the political nature of Canadian parliamentary proceedings.

Background

Employee stock option benefits are subject to taxation as employment income and employees are eligible to claim a deduction of 50% of the benefits, provided certain conditions are met. This taxation approach aligns the treatment of employee stock options with that of capital gains, as both are subject to a 50% inclusion rate.

Proposed changes

The 2024 federal Budget proposed an increase in the capital gains inclusion rate from 50% to 66.67% for capital gains realized after June 24, 2024, and a corresponding reduction in the stock option deduction from 50% to 33.33%. As a result, once enacted, 66.67% of the employee stock option benefits from the exercise of qualifying options would now be taxable. For individuals, the proposed changes would only apply above a combined annual limit of $250,000 for employee stock option benefits and capital gains. For more details on the proposed changes, please refer to our Canadian Tax & Legal Alert of May 6, 2024.

Managing risk and uncertainty in the interim

Despite the recent legislative proposals, employee stock options can still serve as a tax-efficient form of compensation. However, the delay in the implementation of these proposed changes creates uncertainty regarding the employer's withholding tax obligation on stock option benefits realized by employees after June 24, 2024.

The key issue is whether employers should withhold taxes at the new 66.67% income inclusion rate on all stock option benefits realized after June 24, 2024, or continue to use the current 50% inclusion rate and only switch to the new inclusion rate when the legislation is enacted.

Assuming that the legislation will eventually be enacted as currently drafted, adopting the new inclusion rate in the interim may help to mitigate risk with respect to any under-withheld amounts, as well as the possibility of

employees facing a balance due when filing their personal income tax returns. However, this means that employees will likely receive fewer shares if the sell-to-cover method is used to manage withholding taxes, arguably creating an opportunity cost to employees for the potential appreciation of those shares.

Alternatively, employers may choose to continue to use the 50% income inclusion rate under the current legislation and only adopt the new inclusion rate when, and if, the proposals receive Royal Assent. In the event of an audit by the Canada Revenue Agency (CRA) for under-withholding, the employer will have to prove that the withholding taxes were sufficient under the legislation at the time of income realization (i.e., at the time of the exercise of stock options/acquisition of shares). Furthermore, assuming the legislation is enacted in its current form, the new inclusion rate will be effective retroactively to transactions that occurred after June 24, 2024. As a result, this approach is likely to give rise to a balance due by employees upon filing their personal income tax returns.

In any case, based on the current revised proposed legislation, the deduction to alleviate the impact of the increase in the inclusion rate on the first $250,000 of combined stock option benefits and capital gains will be claimed by individuals at the time of filing their personal income tax returns **and does not impact the employer's withholding tax obligation**. Employers will be expected to withhold based on the 66.67% inclusion rate on all employee stock option benefits realized after June 24, 2024, **without regard to the additional deduction.**

Finally, in any case, separate tracking of stock option benefits realized up to June 24 and thereafter is required, as the information will need to be reported in different boxes based on the 2024 T4 and Relevé 1 tax slips recently released by the CRA and Revenu Québec. The employer should ensure that its Employee Share Plan administrator (if any) is aligned on each party's responsibilities and its position with respect to the adoption of the new income inclusion rate.

Employee communication

In the meantime, until Royal Assent, the decision as to whether employers should adopt the new inclusion rate when withholding taxes on stock option benefits realized after June 24, 2024, may be a double-edged sword.

However, regardless of the approach taken by an employer, effective communication with employees will be key to managing expectations. In either scenario, clear and timely communication to employees about the potential impact of the proposed changes, the employer's chosen approach for tax withholding purposes, and any subsequent updates or changes to the process will be paramount. This will enable employees to understand their tax obligations, ensure a positive employee experience, and avoid potential disputes. In addition, as it remains unclear as to when the legislation will be enacted, employers should consider providing regular updates and ensuring that employees have access to resources or assistance to help them navigate these changes.

Documentation

As noted above, if the employer chooses not to adopt the new inclusion rate until the legislation is enacted, it is important to ensure that proper documentation is in place to defend a potential payroll audit. Given the long delay in implementing the proposed changes, it is uncertain how the CRA would address under-withholding tax, when and if the legislation is finally enacted. However, employers would likely be required to make books and records available in the event that the CRA requests substantiation for the adequacy of withholding taxes on stock option transactions.

Finally, it is also prudent to document and communicate with the employees the approach adopted by the employer to be able to demonstrate the employer's due diligence in case of potential disputes and to ensure there are no surprises for the employees.

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Status quo

Approach #1: Employers choose to maintain their current practice of considering a 50% inclusion benefit rate based on the current state of the law.

Impact for employees

Pros:

- **No change to current practice.**
- **Stock options settled through a cashless exercise or a sale-to-cover mechanism:** Employees will not be required to sell more shares than may be necessary, assuming a 50% inclusion rate.

Cons:

- **More complex tax filing:** Employees may need to make adjustments on their tax return to accurately reflect the changes, if enacted as planned. This could result in a more complex tax filing process and potentially require additional calculations or documentation. In any case, employees will need to ensure that they claim the additional tax deduction that will be available for capital gains and stock option benefits up to $250,000.
- **Possibility of facing a significant balance due:** Depending on the individual circumstances and the impact of the new inclusion rate, employees may face a significant balance due when filing their tax returns if the withholding taxes deducted by the employer are insufficient to cover the tax liability resulting from the adjusted inclusion benefit rate. Employees may need to find a solution to effectively manage their cash flow in such situations.

Impact for employers

Pros:

- **No change to current practice.**
- There are no adjustments needed to the payroll system to reflect the new benefit inclusion and taxation rates. There is also no need to engage in discussions with the share plan administrator to coordinate any changes.
- Employers will need to separately track stock option benefits realized up to June 24, 2024, and thereafter, as separate reporting will be required on the 2024 T4 and Relevé 1 tax slips. This is in addition to also separately tracking qualifying versus non-qualifying stock option exercises following the 2021 changes. Employers must have a robust system in place to facilitate compliance with the applicable legislation.

Cons:

- **Risk with respect to any under-withheld amounts:** This could lead to potentially having to engage into objection procedures and professional fees.
- Employers will need to have the information to properly report the correct stock option deduction on the employees' T4 and Relevé 1 tax slips if the legislation is enacted as planned for 2024.
- Employers may face potential claims from employees who argue that the employer did not act in their best interest when deciding to withhold taxes on stock option benefits.

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Updating the benefit inclusion rate

Approach #2: Employers choose to withhold taxes on stock option benefits realized after June 24, 2024, at the higher 66.67% benefit inclusion rate, assuming that the legislation will be enacted by the end of the year.

Impact for employees	**Pros:** • **Minimize the likelihood of a substantial balance due:** When employees file their tax returns, they may be eligible for a refund of any excess withholding if they are below the annual limit of $250,000 for employee stock option benefits and capital gains, or simply in the event that the legislation is not enacted. **Cons:** • **Stock options settled through a cashless exercise or a sale-to-cover mechanism:** Employees may be required to **sell more shares** than necessary, assuming a 66.67% inclusion rate.
Impact for employers	**Pros:** • **Retroactive effect:** Employers who choose to withhold taxes at the higher rate can **reduce the risk with respect to any under-withheld amounts**. **Cons:** • **Changes:** This option requires payroll updates, coordination with share plan administrator (as applicable), and effective communication with employees. Changes may need to be voided or reversed if the legislation is not enacted. • Employers may face potential claims from employees, arguing that the employer did not act in their best interest when deciding to withhold taxes on stock option benefits.

How can Deloitte support clients?

- **Recommending an approach:** Engage in discussions with employers to understand their specific circumstances. By analyzing the stock option plan, we can provide tailored recommendations based on the employer's needs.
- **Assessing the pros and cons:** Evaluate the advantages and disadvantages of each approach, taking into account the employer's stock option plan and other key considerations specific to the employer, such as the company's financial situation, company culture, and employee demographics.
- **Drafting employee communications:** Assist employers in creating comprehensive documents, such as FAQs, to address common queries related to the legislative updates. These documents will help provide clarity to employees and ensure consistent messaging across the organization.
- **Navigating the complexity:** Discussing and communicating to help employers navigate through the complexity of the legislative updates to stock option taxation in Canada in recent years, including the changes that occurred in 2021.
- **Understanding the impact in a mobility context:** Discuss the unique challenges faced by employers with mobile workforces or non-resident employees, including the impact of tax reimbursement policies and income allocation for foreign tax credit purposes.

Please contact Guy Jason, Amélie Desrochers, Chantal Baril or Audrey Bessette for more information or to discuss this further.

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