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Canadian tax alert

Stock option deduction changes expected with new Federal government

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Canada's new Liberal majority government campaigned on a promise to change the tax treatment currently accorded to stock option benefits. How this promise will translate into legislative reality remains to be seen, but timely actions may help mitigate any adverse consequences – at least in the short-run. This newsletter reviews the current stock option rules, the campaign promises to change the current rules, who this will impact, and possible measures to mitigate the impact.

Current rules

Under the Canadian *Income Tax Act* (the Act), when an employee exercises a stock option pursuant to a stock option agreement made under section 7 of the Act, a taxable benefit equal to the difference between the fair market value (FMV) of the share and the price paid for the share will be included in the employee's taxable income for the year. However, the Act permits the employee to claim a corresponding deduction, referred to as the 110(1)(d) deduction, equal to 50% of the taxable benefit where certain conditions are met (namely, that the share is a common share and the price paid for the share is not less than the FMV of the share when the option was granted). Where the employer issues the employee shares, the employer will not be entitled to a corporate deduction. However, where the employee requests cash versus shares, the employer is allowed a corporate deduction for the expense unless it elects to allow the employee to claim the 110(1)(d) deduction. In practice, cash-outs are rare. The 110(1)(d) deduction allows many employees to enjoy the equivalent to capital gains treatment from a tax rate perspective on potentially large amounts of compensation. Accordingly, many compensation packages are structured, at least in part, to include this form of incentive compensation.

It should be noted that where an employee exercises stock options granted by a Canadian-Controlled Private Corporation (CCPC), as defined by the Act, the timing of the taxable benefit and corresponding deduction are governed by a slightly modified regime under the Act, with an alternate deduction provided for in paragraph 110(1)(d.1) for CCPC option shares that have been held for at least two years.

Possible changes to the 110(1)(d)/(d.1) deduction?

The new Liberal government's platform included plans to amend the 110(1)(d)/(d.1) deduction. According to Liberal campaign literature, as part of a "wide-ranging review of complex tax expenditures", it will look for opportunities to reduce tax benefits that substantially benefit those earning in excess of $200,000 per year. The Liberals

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stated that a starting point for this review would be to cap how much an employee can claim under the 110(1)(d)/(d.1) deduction. Some comfort can be taken in the fact that they also said that any changes will recognize that stock options are a useful compensation tool for "start-up companies" and will ensure that employees having up to $100,000 in annual stock option benefits would be unaffected by the cap. We note that no guidance was provided on defining a "start-up company" for these purposes or how they would determine the $100,000 value of the stock option benefit.

To illustrate the impact of the change to the 110(1)(d)/(d.1) deduction, consider an individual who exercises an employee stock option which is subject to the top tax rates in Canada and Ontario, and due to the proposed rules, is not eligible for the 110(1)(d)/(d.1) deduction. In this case, the individual's top tax rate could increase from 24.77% to up to 53.53% on the income from the stock option (assuming the Liberal Party's proposed increase in personal income tax rates is implemented).

It is also not clear, at this time, what the effective date for any proposed changes may be (for example, whether they will apply to any options exercised as of the date of the Budget that introduces the above changes, or whether, which is less likely, the changes will apply retroactively).

Who may be impacted by the change

Depending on how any rule changes are implemented, the changes could impact a number of groups of people including:

- Employees with vested yet unexercised stock options;
- Employees with unvested stock options;
- Employers and employees during compensation negotiations;
- Employer's withholding practices; and
- Non-resident employers with tax equalized employees who earn Canadian-source stock option benefits.

The accounting treatment of stock option benefits of public companies would also need to be reviewed for the potential impact.

How to mitigate the impact

Based on long-standing past practices of the Federal government, Deloitte anticipates that any changes will likely be on a prospective basis only. That said, it is important for clients to consider the potential changes to the regime in a timely manner and companies may want to communicate with employees who may be affected to allow them to best manage their affairs. For instance, employees with vested yet unexercised stock options may want consider the timing of future exercises of options and employers may want to provide employees with unvested stock options opportunities to exercise options in the current favorable environment through the acceleration of vesting of the options. Further, Deloitte can work proactively with employers to help them in the amending of their governance, accounting, and withholding practices to be compliant with the new laws as they come into force.

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