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Employee stock options – anticipated modifications

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During the recent election campaign, the Liberal party – which has now formed a majority government - made a number of pledges relating to the taxation of individuals, including promises to increase the top marginal tax rate by 4% and to eliminate the employee stock option deduction in a number of situations. As set out in the chart below, the cumulative impact of these changes will be significant. For example, the top tax rate on stock options could be increase from approximately 25% to 54%.

Combined federal & provincial top personal income tax rates

Province	Current 2015 rates	Current stock option rates	Expected 2016 rates
Alberta	40.25%	20.13%	48.00%
British Columbia	45.80%	22.90%	47.70%
Manitoba	46.40%	23.20%	50.40%
New Brunswick	54.75%	27.38%	58.75%
Newfoundland & Labrador	43.30%	21.65%	48.30%
Nova Scotia	50.00%	25.00%	54.00%
Ontario	49.53%	24.77%	53.53%
Prince Edward Island	47.37%	23.69%	51.37%
Quebec	49.97%	31.42%	53.31%
Saskatchewan	44.00%	22.00%	48.00%

Notes:

- Current stock option rates assume that the particular stock option benefit is eligible for the 50% stock option deduction under paragraphs 110(1)(d)/(d.1) of the Canadian Income Tax Act.

- The Quebec rate of 31.42% considers that only 25% of the stock option benefit is eligible for a deduction (unless the share is of a qualifying small or medium-sized business carrying out innovative activities).

- Expected 2016 rates include: i) the addition of the anticipated fifth federal personal income tax bracket at a rate of 33%; ii) Alberta's 3.75% increase to its top marginal rate, resulting in a 15% top marginal rate; iii) British Columbia's elimination of the current top marginal tax bracket of 16.8%, resulting in a 14.7% top marginal rate; iv) Newfoundland & Labrador's

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1% increase resulting in a 15.3% top marginal rate, and v) Quebec's elimination of its stock option deduction.

- The expected 2016 rates will apply to all taxable income, including stock option benefits, which will not otherwise qualify for favourable tax treatment, if any, under the new Liberal government.

No details have yet been released. At this stage, there is no certainty with respect to the effective date of the modifications. While we do not anticipate that the modifications will be retroactive to the date of the election, no guarantee can be made on this point. We expect that the government will seek to implement at least some of these changes as soon as possible. We therefore suggest that readers consider our comments below in preparation for the anticipated implementation of these changes.

Accelerating bonus payments

Where bonus or other types of deferred compensation payments (such as restricted stock units) have been postponed, we recommend that employers consider accelerating these payments to address the potential impact of an increase in the marginal tax rate. In determining whether to accelerate payments, it is important to keep the following issues in mind:

- Accelerating payments may also increase the provincial payroll tax rates where the employer pays compensation in a province that imposes a payroll tax.
- Prior to accelerating a deferred bonus of an executive subject to US taxation, the background of the bonus should be reviewed to confirm that the acceleration will not result in the imposition of punitive US tax rates pursuant to section 409A of the Internal Revenue Code. Where the requirements of section 409A are breached, the individual's US federal tax rate may ultimately approximate 60%. In general, where a bonus was previously exempted from section 409A because it was to be paid on a set date, accelerating the bonus payments is not advisable.

Stock option considerations

Vested but unexercised options

Under all circumstances, employers should recommend that executives holding vested but unexercised options consult with their tax advisors to understand the potential impact of the government proposals. Executives may wish to consider whether it would be advisable to exercise their options as soon as possible. Deloitte can work with employers to draft employee communication.

If the options are to acquire shares of a Canadian-controlled private corporation (CCPC), it is possible that the stock option deduction denial could be drafted to apply to the benefit arising on the sale of the shares after the effective date, even if the options were exercised and the shares were acquired before that date. For this reason, private company employers may wish to consider mechanisms to allow the employees to sell their shares and thus trigger the stock option benefit and deduction where available.

International employers should also consider the impact of the proposed stock option deduction changes on their equalization costs. When executives are on assignment to Canada and their assignment agreement ensures that their after-tax income remains the same as if they had remained subject only to the lower tax rates in their

home countries, the preferential tax treatment of option awards in Canada has traditionally reduced the overall Canadian tax rate for the purpose of calculating equalization payments. Unfortunately, the potential elimination of stock option deductions will increase potential equalization costs. Deloitte can assist clients in understanding the potential cost implications of the proposed tax changes.

Unvested options

At the employer's discretion, the vesting of unvested options can typically be accelerated. The issues to consider in these circumstances are:

- At this stage, we cannot predict the effective date of the modifications. While we would hope for appropriate transitional rules, there is no certainty that options issued before the election will be exempted from these new provisions.
- In most jurisdictions, vesting acceleration should not adversely impact the individual's taxation. However, whenever the option benefit will also be taxed in another country, the foreign tax consequences should also be confirmed.
- Vesting acceleration may impact the accounting treatment of and financial reporting for the options. It is strongly recommended that the accounting implications be reviewed.
- Shareholders and other stakeholders may raise concerns regarding the dilution arising when executives exercise an increased number of options in a concentrated period of time. In addition, it is reasonable to expect that shareholders will have questions regarding corporate governance, the impact of the modifications on executive motivation, and the financial implications associated with executives reloading on options in order to preserve the economics in any remaining term to expiry.
- Executives may be unable to take advantage of an early vesting window due to personal financial constraints or regulatory restrictions, such as "blackout" restrictions limiting the ability of senior executives to deal in the publicly-traded shares of their employer.
- The proposed modifications to the option deduction may also lead to a modification permitting a corporate deduction for stock option benefits. If Canadian tax legislation is modified in this manner, accelerating the vesting and exercise of options in order to ensure that plan participants are able to claim favourable tax treatment could deprive the employer of an opportunity to claim a deduction.

In considering steps that can be taken to address these concerns, early consultation with professional advisors is recommended. Deloitte can work with employers to address these issues.

On a preliminary basis, we suggest that in the appropriate circumstances, the following steps could address the concerns of shareholders and executives.

- Dilution concerns can be mitigated by implementing a net share settlement program under which employees may elect to surrender their options and receive shares with a value equal to the spread between the aggregate exercise price and the fair market value of the shares at the date the options were surrendered. It should be noted that if the options qualified for the special CCPC deferral, such deferral will not be available when the individual elects to surrender the options.
- In the alternative, the employer may wish to consider implementing a program to buy back shares on the open market equal to the number of additional shares that executives acquire following the acceleration of the vesting of the options, so as to reduce the dilutive effect.

- Shareholder concerns regarding vesting accelerations and the impact on executive motivation can be addressed by requiring employees to retain their shares following an exercise. However, such plans should be structured to recognize the need of the company to withhold and remit taxes, such obligations being frequently satisfied from the proceeds recognized when the employee sells the shares on the open market.
- Concerns of executives regarding their personal financial constraints can be addressed through loan programs (where regulatory restrictions on executive loans are not relevant). However, such loans must be carefully structured to avoid adverse tax consequences.
- As an alternative, the options could be exchanged for options with a reduced exercise price but the same intrinsic value without adverse Canadian tax consequences. However, the impact on financial reporting for the employer and tax implications for executives subject to taxation outside of Canada should be carefully reviewed.

Additional considerations for CCPCs

In the past, when the stock option deduction rates were modified for federal tax purposes, the applicable rate was determined when the benefit was included in income. While past practice is not determinative, many executives may consider selling their shares in order to crystallize the claim and potentially preserve the deduction. However, a CCPC shareholder has additional issues to consider before selling his/her shares in contemplation of the proposed changes, namely:

- If the individual must retain the shares for two years in order to obtain preferential tax treatment, will this requirement be satisfied?
- What is the market for the shares? In particular, if the shares are sold back to the issuer, a taxable Canadian corporation, it is likely that at least a portion of the proceeds will be characterized as a deemed dividend due to the fact that the deemed dividend is calculated by reference to the difference between the proceeds of disposition and the paid-up capital. Paid-up capital does not include the employment benefit received when an employee exercises shares for less than fair market value.
- The terms of existing shareholder agreements should be reviewed to confirm the restrictions on share dispositions, including any rights of first refusal, drag along rights and other provisions that could affect such a transaction.
- In some instances, a disposition of shares by a significant number of employee/shareholders could have other tax implications.

Top-up payments

Where it is not practical to accelerate the vesting and exercise of options or the executive cannot exercise the options due to blackout restrictions, the employer can agree to “top up” the executive’s compensation in recognition of the increased taxes on the stock option benefit. However, as such payments will be considered a taxable benefit, the payments should be grossed-up to reflect these additional taxes if the employer intends to completely shield the executive from the tax impact of the proposed changes. Such payments can be costly and the potential future costs should be carefully reviewed before entering into any undertakings.

Be prepared

At this time, there is no certainty as to the nature of the final changes to stock option benefits or as to the timing of the implementation of the changes.. However, changes are anticipated. We recommend that employers start to review the alternatives as soon as possible so that they can be prepared to respond.

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