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## Canadian tax alert

### Stock option amendments – prospectivity promised

November 24, 2015

Following the recent federal election, the anticipated changes to employee stock option taxation have created significant concern. One of the major issues facing employers and employees has been whether outstanding options and crystallized but as yet untaxed option benefits would be subject to the anticipated amendments. On November 20, 2015, Finance Minister Bill Morneau released the Update of 2015 Economic and Fiscal Projections. In response to a question after the presentation, he indicated that the stock option amendments will not be enacted retroactively and that the current tax provisions will continue to apply to options issued prior to the date on which the details of the changes are released. Mr. Morneau noted that aspects of the amendments have yet to be finalized.

The Minister's response demonstrates that the government is sensitive to the potential disruptive impact of these changes and is concerned about the potential consequences as employers and employees attempt to respond to the anticipated amendments.

As proposals have not yet been finalized, a number of issues that will affect the efficacy of existing company stock option programs are yet to be determined. Questions that remain outstanding include: whether the \$100,000 annual option benefit exemption will be eligible for carryforward and aggregation when shares are illiquid or other circumstances inhibit annual exercises; how will a "start-up" be defined; and whether the proposed legislation will contain transitional measures in order to gradually reduce the stock option deduction over time. We urge interested parties to reach out to the government to share their insights on the impact of the potential modifications and ensure that all issues are thoroughly considered.

In the interim, as we await details of the changes, employers should consider accelerating the granting of options that would otherwise have been issued to key employees at a later date. Of course, the financial reporting implications of the increased option grant and stakeholder concerns should be addressed.

In particular, stakeholders may raise concerns regarding the accelerated dilution of their interests. This issue can be addressed by extending the vesting period to match the vesting dates that would have been imposed if the options had been issued in the normal course. In addition, the employers could consider implementing mandatory retention requirements and net settlement arrangements under which the option holders can elect to surrender their options for shares and, where required for tax withholding purposes, cash. When structuring a mandatory retention program, it will

be important to consider potential tax withholding obligations and the ability of option holders to satisfy these requirements if they are unable to sell their shares. Net settlement arrangements should also be reviewed for global tax consequences where option holders are subject to tax in more than one jurisdiction and the potential impact on the compensation expense recorded on financial statements.

Longer term, employers may wish to review their overall compensation strategy and consider whether additional or alternative incentive programs could be put in place to supplement the stock option plans when the option holders may be unable to claim a stock option deduction. If the proposed amendments do not contain provisions creating an employer deduction for stock settled compensation, programs including cash settled restricted share units, deferred share units or stock/unit appreciation rights can replicate many of the attributes of stock settled programs while ensuring an employer deduction. While such plans will not completely replace share incentive plans, they do not give rise to the same dilution issues. Further, unlike traditional stock option plans, these programs have fixed distribution dates, enabling employers to tailor the plans to the business cycle rather than leaving the distribution timing to the option holders.

However, we anticipate that equity incentive programs will remain a key component of employer incentive strategy due to their relative flexibility and negligible cash flow implications. With the anticipated restriction to the stock option deduction, we expect that new opportunities will arise for employers to structure stock incentive plans that address their strategic needs yet provide meaningful employee rewards. Under such plans, clients could offer in the money options in lieu of a bonus and consider other more creative ways to structure stock settled remuneration.

*Anne Montgomery, Toronto*

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