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Budget 2019 limits employee stock option benefits but signals possible tax deductions for employers

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Authors: Dov Begun, Lynne Lacoursière, Hemant Tilak, Colena Der

Employee stock options have traditionally been used in companies to attract, reward and retain employees. Under the *Income Tax Act* (Canada) (Tax Act), when an employee exercises the stock option and acquires the shares, the employee realizes a taxable employment benefit equal to the excess of the value of the shares at the time of acquisition over the exercise price paid for the shares. When the exercise price of the option is fixed at an amount that is not less than the fair market value of the share at the time the option was granted, and provided certain other conditions are met, the employee can claim a deduction equal to one-half of the taxable benefit (the Stock Option Deduction). Where this deduction is available, it results in a preferential tax rate for employee stock options that is the same as the tax rate applicable to capital gains.

Limiting stock option benefits

The 2019 federal budget (the Budget) proposes to impose an annual cap on stock options granted to an employee that will be eligible for the Stock Option Deduction. The cap will only apply to employees of “large, long-established, mature firms” (which was undefined in the Budget). The annual cap of $200,000 is based on the fair market value of the underlying shares at the time that the options are granted to an employee. Options granted to an employee beyond that cap will not be eligible for the Stock Option Deduction.

In its 2015 election platform, the Liberal party proposed to limit the tax benefits afforded to employee stock options by imposing a cap that would apply to employees with over $100,000 in annual stock option gains. That proposal was ultimately abandoned in 2016 after start-up companies cautioned that this measure would adversely affect their ability to recruit and retain employees. The Budget proposal appears to address these concerns by expressly excluding employees of “start-ups and rapidly growing Canadian businesses” from the $200,000 annual cap.

Draft legislation was not released, but the Budget sets out several examples to illustrate how the proposal would operate. The first example involves an executive at a mature company receiving options to acquire 100,000 shares. At the time of the option grant, the fair market value of each share is $50. The cap would apply in this case so that only 4,000 of the 100,000 options ($200,000 ÷ $50 = 4,000) would be eligible for the Stock Option Deduction, but the remaining 96,000 options would not be eligible for the Stock Option Deduction.

Possible tax deduction for employers

The Tax Act has included a longstanding prohibition on a corporate level deduction where shares are issued to settle employee stock options. However, the Budget indicates that an employer may become entitled to a tax deduction for the benefits that are fully taxed in the hands of the employees—that is, for options not eligible for the Stock Option Deduction.

This would represent a significant change in tax policy. While the only reference to the corporate deduction in the Budget materials is in the last sentence of the example, our understanding is that the reference was deliberate and that the Department of Finance's intention is to provide such a corporate level deduction, subject to any consultation process. The actual statutory mechanism for this deduction remains to be determined, including how it would interact with other restrictions in the Tax Act on the deductibility of share expenditures (for example, the rule in subsection 143.3(3) and the general prohibition on deducting capital expenditures in paragraph 18(1)(b)).

Impact on incentive arrangements

Given the potential for a corporate level deduction for non-eligible options, the proposed changes could have a material impact on the effectiveness of stock options as an incentive tool and the preference between stock options and share-settled restricted share units. For example, if the employee is not eligible for the Stock Option Deduction on a portion of the options granted, the employee and employer may prefer alternative forms of long-term incentive awards such as share-settled restricted or performance share units. The proposal could also reduce the attractiveness of discretionary share-settled bonus plans.

Prospective application

The Budget indicates that any new measures would only apply on a going-forward basis and will not apply to any employee stock options granted prior to the announcement of legislative proposals. Further details will be released before the end of summer 2019. We expect the government will provide for a consultation process following the release of a more detailed proposal or draft legislation.