

Proposed Changes to the Tax Treatment of Employee Stock Options



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On Monday, June 17, 2019, the Department of Finance released legislative changes to the taxation of stock options in Canada, as announced in the 2019 Federal Budget.

Currently, preferential treatment is available on stock options granted that meet certain criteria, by allowing for a deduction such that only half of the stock option benefit is taxable. The proposed CRA tax rules will eliminate this deduction on stock options granted on or after January 1, 2020, but will not apply to:

- Canadian-controlled private corporations ("CCPCs").
- The first \$200,000 of employee stock options granted by non-CCPCs that vest in a calendar year. This \$200,000 limit refers to the fair market value ("FMV") of the underlying shares at the time the stock options are granted.
- Certain non-CCPCs, which meet prescribed conditions as "start-ups, emerging or scale-up companies." The Federal Government is seeking input from stakeholders, to be submitted by September 16, 2019, to determine what characteristics a company must have to meet these conditions.

Where the exceptions above are not met:

- Employees will be fully taxed on the stock option benefit (previously eligible for the 50% deduction).
- Employers will be eligible for a deduction equal to the stock option benefit included in the employee's income.

There are a number of nuances to these legislative changes to the taxation of stock options that are beyond the scope of this article, such as the ordering of stock options qualifying for preferential treatment, options and requirements for employers including administrative and tax compliance matters, etc.

Department of Finance example (modified):

Stock option is granted in 2020 by a non-CCPC not eligible for the "start-ups, emerging or scale-up" exception to acquire 50,000 shares at \$50 per share (FMV at the time of grant), vesting in 2021.

The options are exercised in 2021 when FMV is \$70 per share:

| | Number of Shares | \$70/share FMV | \$50/share Exercise Price | Stock Option Benefit | 50% Deduction | Total |
|-----------------|------------------|--------------------|---------------------------|----------------------|-----------------|------------------|
| First \$200,000 | 4,000 | \$280,000 | \$200,000 | \$80,000 | \$40,000* | \$40,000 |
| Remainder | 46,000 | 3,220,000 | 2,300,000 | 920,000 | NIL | 920,000 |
| Total | 50,000 | \$3,500,000 | \$2,500,000 | \$1,000,000 | \$40,000 | \$960,000 |

** Exercise price is at least equal to the FMV at the time the options were granted and assumes that the shares meet the definition of prescribed shares (Regulation 6204(1)) and the employee deals at arm's length with the corporation.*

The effect of changes to the taxation of stock options in this example is significant in that only a small portion of the benefit is eligible for half taxation, leaving most of it to be fully taxable. Under the old CRA tax rules, there would have been an additional \$460,000¹ of deduction, sheltering almost another \$230,000 of taxes payable in BC (at the top tax rate).

As mentioned above, the benefit of this deduction is still available to CCPCs and non-CCPCs meeting the "start-ups, emerging or scale-up" exception.

As the taxation of stock options is payable at the time of exercise, stock option holders who are affected would be wise to hold off exercising their options until the time of sale of the underlying

shares, to defer the tax payable until funds are realized on the sale.

Companies that are affected by the legislative changes to the taxation of stock options should consider whether to grant additional stock options before and/or limit stock options granted after the new rules come into effect.

Please contact **Wendy Seet** or **Simran Bhatti** of the Manning Elliott Tax Team with any questions by submitting a contact form inquiry.

¹Equal to the deduction under the old rules of 50% of the total benefit (i.e. \$500,000) less the deduction available under the new rules

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