Employee stock options

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On July 1, 2021, new stock option rules came into force which limit the preferential tax treatment associated with certain employee stock options for employees at large, long-established, mature firms. The public policy rationale previously cited by the government for the preferential tax treatment of employee stock options was to support younger and growing Canadian businesses.

Here's a quick overview of how employee stock options work, and the tax treatment for options granted prior to and after July 1, 2021.

What are employee stock options?

Employee stock options are used by employers as part of their total compensation package. Employees are granted the right to purchase company stock at a predetermined price, generally for a predetermined period of time. It's become especially popular for start-ups and smaller growth companies, who don't have much in the way of cash flow (or profits), to offer potential recruits stock options in lieu of cash, which ties their compensation to the future success of the company. A variety of employers use employee stock options to entice and retain skilled workers.

Tax rules for options granted before July 1, 2021

When an employee stock option that was granted before July 1, 2021 is exercised, the difference between the exercise price and the fair market value of the share is included in income as an employment benefit.[1] For qualifying options[2], you can claim an offsetting deduction (the "stock option deduction") equal to 50% of the benefit, so that only 50% of the stop option benefit is taxed at your marginal tax rate.[3] The tax result is to effectively tax the benefit associated with the exercise of employee stock options as if it were a capital gain, although technically, the income is still considered to be employment income.[4]

Tax rules for options granted as of July 1, 2021

Employees

For options granted by certain companies on or after July 1, 2021, a $200,000 annual cap applies to the amount of employee stock options that may "vest" for an employee in a year and continue to qualify for the stock option deduction. No changes have been made to the initial income inclusion; rather, this cap only applies to the ability to claim the 50% stock option deduction. An option is said to vest when it first becomes exercisable.[5] For the purpose of determining the amount of options that vest in any calendar year, the value of those options will be the fair market value of the underlying shares when the options were granted.

If an employee exercises an employee stock option that exceeds the $200,000 limit in a particular vesting year, the difference between the fair market value of the share at the time the option is exercised and the exercise price paid by the employee to acquire the share will simply be treated as employment income and will be fully taxable, making it consistent with the treatment of other forms of employment income such as salary, wages or a bonus. In other words, the employee won't be entitled to the stock option deduction on the exercise of these options.

Where an employee works for more than one employer, the $200,000 annual limit is combined where employers do not deal at arm's length; however, if the employers deal at arm's length with one another, then a separate $200,000 cap applies to each such employer.

These new tax rules only apply to employee stock options granted after June 30, 2021. The former rules continue to apply to options granted before July 1, 2021.[6]

Employers

Generally, an employer is not entitled to a deduction for tax purposes in respect of employee stock options. However, where the employee is not entitled to the 50% stock option deduction, the employer will be entitled to a tax deduction for the amount of the stock option benefit included in the employee's income.

Employers are required to notify employees where options granted will not be eligible for the 50% stock option deduction.

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1 For employee stock options granted by Canadian-controlled private corporations (CCPCs), the income inclusion is generally deferred until the securities are sold.

2 To qualify for this deduction, among other requirements, the option price cannot be less than the fair market value of the securities at the time the option was granted. For CCPCs, options will also qualify if the employee was dealing at arm's length with the employer, and the shares are held for at least two years after being acquired.

3 For residents of Quebec, the provincial stock option deduction may be reduced in some cases.

4 This distinction is important, particularly because capital losses that an employee may have realized cannot be used to offset the employment benefit associated with the exercise of employee stock options.

5 If it is not clear when an option vests, it will be considered to vest on a pro-rata basis over the term of the option agreement, for a maximum of five years.

6 Changes have been made to the rules governing alternative minimum tax (AMT) effective for the 2024 and subsequent years. It is possible that the exercise of stock options after 2023 where the employee is entitled to the stock option deduction will result in AMT. Further information is available in the CIBC report The new Alternative Minimum Tax (AMT)

Exempt companies

Stock options offered by CCPCs are exempt from the rules limiting the amount of options eligible for the stock option deduction. In addition, options granted by non-CCPC employers whose annual gross revenue does not exceed $500 million are generally not subject to the limitation on the availability of the stock option deduction.

Employers that are exempt from the limitation do not have the option to opt in to the new rules (which may have been desirable should they have been able to deduct the stock option benefit from their income).

Examples

To illustrate, let's say Amil is an executive at Plumbing Co., a large, mature Canadian public company, and Amil is awarded 20,000 stock options in January 2024. The exercise price is $10 (which is equal to the share price when the options are issued) and the options expire in ten years, in 2034, and vest after three years, in 2027. The value of Amil's options that vest in 2027 is $200,000. Lynn, also works at Plumbing Co. Lynn is granted 30,000 stock options in January 2024 (at the same $10 exercise price and vesting period.) The value of Lynn's options that vest in 2027 is $300,000.

All of Amil's 2024 options, which vest in 2027, would be eligible for the stock option deduction. The total amount of options that vest for Amil in 2027 is $200,000 (in other words, 20,000 shares times $10 per share). This does not exceed the maximum amount of $200,000 in option value that may vest in a year and be eligible for the stock option deduction.

This holds true regardless of the price of Plumbing Co. shares when Amil exercises the options, and the year in which he exercises the options. So, if Amil exercises the options in 2028 when the shares have tripled in price to $30, then Amil's entire stock option benefit of $400,000 (20,000 times ($30 minus $10)) would be eligible for the 50% stock option deduction and Amil would pay tax on $200,000 (being 50% of $400,000) in 2028 at his marginal tax rate.

If Lynn also exercises her options in 2028, only part of her stock option benefit will be eligible for the 50% stock option deduction since the total value of options that vested in 2027 (30,000 times $10) is $300,000, which exceeds the $200,000 annual vesting limit. The stock option benefit of $400,000 on the first 20,000 options granted (20,000 times ($30 minus $10)) will be eligible for a $200,000 stock option deduction. However, for the last 10,000 of options exercised, Lynn will have an income inclusion of the stock option benefit of $200,000 (10,000 times ($30 minus $10)), and no stock option deduction will be available.

Charitable donations

If an employee donates a publicly listed share acquired under an employee stock option agreement to a registered charity within 30 days of the exercise of the option (and in the same calendar year as exercise) and the stock option deduction is available, they may be entitled to a further deduction of 50% of the stock option benefit,. This deduction is also available if the employee directs a broker to immediately dispose of the share acquired, and to pay the proceeds to the charity. In these situations, the entire employee stock option benefit is effectively tax-free.[7]

As of July 2021, if an employee donates a publicly-listed share acquired under a stock option that is no longer eligible for the 50% employee stock option deduction, then this additional 50% deduction will also no longer be available. This will also be the case where the employee directs a broker to immediately dispose of the shares acquired, and to pay the proceeds to the charity.

7 It is possible that the donation of securities obtained from the exercise of stock options after 2023 where the employee is entitled to the stock option deduction will result in AMT. Further information is available in our report Alternative minimum tax: Impact on charitable giving.

That being said, a donation tax credit can still be claimed for the fair market value of the shares being donated (or the sale proceeds). In addition, any capital gain that has accrued between the date the shares were acquired under the stock option agreement and the date they were donated to charity would continue to be eligible for the full exemption from capital gains tax.

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