Everything You Need to Know About the Government's New Stock Option Taxation Rules

July 2019

A version of this article originally appeared in the National Post on June 28, 2019

Jamie Golombek
Managing Director, Tax & Estate Planning, CIBC Financial Planning and Advice

On June 17, 2019, the federal government introduced draft legislation that proposes to limit the preferential tax treatment associated with certain employee stock options. The new rules, originally introduced in the March 2019 federal budget, fulfill a 2015 Liberal party election platform promise to limit the benefits of the stock option deduction by placing a cap on how much can be claimed. At the time, the Liberals quoted a Department of Finance estimate which found that 8,000 “very high-income Canadians deduct an average of $400,000 from their taxable incomes via stock options.”

In the backgrounder accompanying the draft legislation, the government updated the data to show that in 2017, 36,630 Canadians claimed, in aggregate, nearly $2.1 billion-worth of stock option deductions on their 2017 tax returns. Among these taxpayers, 2,300 individuals, each with a total personal annual income of over $1 million, accounted for nearly two-thirds of the $2.1 billion in stock option deductions claimed.

Here’s a quick overview of how employee stock options work, the current and proposed tax treatment, along with some other considerations.

Who Uses Stock Options?

Employee stock options are used by some corporations as part of their total compensation package to entice and retain skilled workers by offering those employees the right to purchase company stock at a predetermined price, generally for a predetermined period of time. These days, it’s become especially popular for startups 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.

Current Rules

Under current tax rules, when an employee stock option is exercised, the difference between the exercise price and the fair market value of the share is included in income as an employment benefit. For qualifying options, you can claim an offsetting deduction (the “stock option deduction”) equal to one-half the benefit, so that only 50 per cent of the stock option benefit is included in your income and taxed at your marginal rate.

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.

http://www.cibc.com
Proposed Rules

The public policy rationale for the preferential tax treatment of employee stock options is “to support younger and growing Canadian businesses.” That being said, the government “does not believe that employee stock options should be used as a tax-preferred method of compensation for executives of large, mature companies.”

To this end, draft legislation was introduced that would set a $200,000 annual cap on the amount of employee stock options that may “vest” for an employee in a year and continue to qualify for the stock option deduction. An option is said to vest when it first becomes exercisable. Employee stock options granted on or after January 1, 2020 would be subject to the new rules.

For example, let’s say Jay is an executive at Plumbing Co., a large, mature Canadian public company, who is awarded 20,000 stock options in 2020. 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 2030) and vest after three years, in 2023.

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. Since Jay’s options were granted in 2020 when the price was $10, then all of Jay’s 2020 options, which vest in 2023, would be eligible for the stock option deduction since the total amount of options that vest in 2023 is $200,000 (in other words, 20,000 X $10).

This holds true regardless of the price of Plumbing Co. shares when Jay exercises the option. So, if Jay exercises the options in 2025 when the shares have tripled in price to $30, then Jay’s entire stock option benefit of $400,000 (20,000 X ($30 – $10)) would be eligible for the 50 per cent stock option deduction and Jay would pay tax on $200,000 in 2025 at his marginal tax rate.

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 be 100 per cent taxable, making it consistent with the treatment of other forms of employment income such as salary, wages and a bonus. In other words, the employee won’t be entitled to the stock option deduction on the exercise of these options.

Exempt Companies

Stock option plans offered by Canadian controlled private companies (CCPCs) will be exempt from the new rules. In addition, some non-CCPCs classified as “startups, emerging, or scale-up companies” could also be exempt from the rules if they meet “certain prescribed conditions.”

To this end, the government launched a consultation process asking Canadians for input as to what, exactly, these prescribed conditions should be. In establishing the prescribed conditions, the government says it will be guided by two key objectives: that the employee stock option tax regime becomes fairer and more equitable and that startups and emerging Canadian businesses that are creating jobs can continue to grow and expand. Specifically, the government is looking for submissions with respect to the characteristics of companies that should be considered startup, emerging, and scale-up companies for purposes of the prescribed conditions.

Charitable Donations

Finally, under the current tax rules, if an employee donates a publicly listed share acquired under an employee stock option agreement within 30 days of the exercise of the option to a registered charity, the entire employee stock option benefit is effectively tax-free and a donation receipt can be received for the fair market value of the shares being donated. Going forward, if an employee donates a publicly listed share acquired under a stock option that is no longer eligible for the 50 per cent stock option deduction, a donation receipt is still available but the full stock option benefit would be taxable.
Jamie.Golombek@cibc.com

Jamie Golombek, CPA, CA, CFP, CLU, TEP is Managing Director, Tax & Estate Planning with CIBC Financial Planning and Advice in Toronto.

As with all planning strategies, you should seek the advice of a qualified tax advisor.

This report is published by CIBC with information that is believed to be accurate at the time of publishing. CIBC and its subsidiaries and affiliates are not liable for any errors or omissions. This report is intended to provide general information and should not be construed as specific legal, lending, or tax advice. Individual circumstances and current events are critical to sound planning; anyone wishing to act on the information in this report should consult with his or her financial advisor and tax specialist.

The CIBC logo is a registered trademark of CIBC.