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TaxNewsFlash

Canada

New Stock Option Regime — Takes Effect July 1, 2021

June 23, 2021
No. 2021-35

Employers that offer employee stock option benefit plans should prepare for upcoming changes to limit the preferential personal tax treatment of those options granted after June 30, 2021 for certain employees. These companies will soon have to apply a $200,000 annual cap on the amount of employee stock options that continue to qualify for the stock option deduction. Although these rules limit the availability of the stock option deduction for certain employees, employers may be entitled to the deduction, if they meet certain conditions. These changes, which are currently making their way through the legislative process, apply to stock options granted by employers that are corporations or mutual fund trusts, but do not apply to Canadian-controlled private corporations (CCPCs) or non-CCPCs with annual gross revenue in the most recent consolidated financial statements that does not exceed $500 million.

Actions to consider

Companies affected by this new annual cap should consider the timing of granting stock options and other stock-based awards before the new rules come into effect. In addition, these companies should be prepared to track and monitor stock option grants and the application of the cap to differentiate the number of options eligible for the stock option deduction. Companies should also ensure that stock option agreements entered into on or after July 1, 2021 clearly state the vesting period of the options if they do not wish for the CRA's new deemed vesting period to apply.

Background

Under the current tax rules, employee stock options can receive preferential personal tax treatment in the form of a deduction (the "stock option deduction"). As a result of this deduction, employment income is effectively taxed at rates similar to capital gains. Generally, where a stock option is granted to an employee of a public company and the exercise price is equal to (or higher than) the value of the shares at the time the option is granted, the employee includes in taxable income, at the time the option is exercised, the amount by which the fair market value of the shares at the date of exercise exceeds the exercise price. In addition, the employee may deduct 50% of that amount as a "stock option deduction" if certain conditions are met.

Relief is also provided where stock options are granted with respect to shares of CCPCs. In this case, the exercise price may be less than the fair market value of the share at the time the option is granted, but the shares must be held for two years after acquisition, or the conditions for stock options (mentioned above) must otherwise be satisfied, for the employee to claim a deduction equal to 50% of the stock option benefit. In addition, for CCPC options, the timing of taxation is deferred until the stock is sold.

Under the current rules, employers are not entitled to a corporate tax deduction for the stock option benefit when they issue securities under the plan. Generally, where options are cash-settled instead, an employee may only be entitled to the stock option deduction if employers elect to forego a corporate tax deduction for the stock option expense.

The new stock option deduction rules are included in the 2021 federal budget implementation bill (Bill C-30), which is currently making its way through the legislative process. Finance first proposed the stock option deduction cap in the 2019 federal budget, and released additional details of this change in the 2020 Fall Economic Statement (see *TaxNewsFlashCanada* 2020-87, "Highlights of the 2020 Federal Fall Economic Update").

Which stock options are subject to the new rules?

Employee stock options that are granted by employers that are corporations or mutual fund trusts will be subject to the new stock option rules. However, these rules do not apply to stock options granted by Canadian-controlled private corporations (CCPCs) or non-CCPCs with annual gross revenue that does not exceed $500 million. For non-CCPCs that are members of a corporate group that prepares consolidated financial statements, gross revenue generally means the consolidated gross revenue reflected in the most recent consolidated annual financial statements of the group presented to shareholders, or unitholders, prior to the date that the stock option is granted.

Where employers grant employee stock options to acquire shares or units of a non-arm's length entity, and either the entity or the employer is subject to the new rules, then the new rules will apply to those options.

How the annual cap applies

Generally, where these rules apply to a stock option agreement, the $200,000 annual limit on the amount of employee stock options that may vest (i.e., when the options first become exercisable) in a calendar year applies to all stock option agreements between the employee and the employer, or any corporation that does not deal at arm's length with the employer. Where these rules apply and an employee exercises an employee stock option that exceeds the $200,000 limit, the employee is not entitled to the stock option deduction.

In addition, the rules stipulate that where an individual has two or more employers who deal at arm's length with each other, that individual has a separate $200,000 annual limit for each of those employers.

The new rules apply to options granted on or after July 1, 2021 (subject to certain exceptions for qualifying options granted on or after July 1, 2021 that replace options granted before that date).

Valuing vested stock options

To determine the value of stock options for purposes of the annual cap, the rules provide that the amount of stock options that may vest in a calendar year is based on the fair market value of the underlying shares at the time that the option is granted. If the year in which an option vests is not clear, the option is considered to vest on a pro-rata basis over the term of the agreement that begins on the day that the agreement was entered into and ends on the earlier of 60 months after that date and the last day on which the employee can acquire securities.

Ordering of acquisition of securities

Where an employee has a number of identical stock options and some qualify for the existing tax treatment while others are subject to the new tax treatment, the employee is considered to first exercise the stock options qualifying for the existing tax treatment.

Additional employer considerations

Optional employer designation

Employers subject to the new rules can choose to designate one or more securities under a stock option agreement as “non-qualified securities” ineligible for the employee stock option deduction, even though the stock options for those securities may otherwise fall under the $200,000 limit (i.e., a non-qualifying securities designation). Where an employer makes this designation, the employee cannot claim the stock option deduction when the option to acquire the non-qualified security is exercised, but the employer may instead be eligible for a deduction for corporate income tax purposes. Employers who choose to make this designation must also follow the appropriate notification requirements.

Employer deduction

For employee stock options that exceed the $200,000 limit (or where the employer has made a non-qualifying securities designation), employers may be entitled to an income tax deduction for the stock option benefit included in the employee's income for shares acquired that are not eligible for the stock option deduction under the new rules. These employers may claim the deduction where the individual would have been entitled to a stock option deduction under the existing rules, and certain other conditions are met. Employers can claim this deduction in their taxation year that includes the day on which the employee exercised the stock option. To claim the deduction the employer must have been the employer of the individual at the time the stock option agreement was entered into and the employer must meet certain notification requirements, among other conditions.

Employer notification requirements

Employers must notify employees in writing that options granted are for non-qualifying securities subject to the new tax treatment no later than 30 days after the agreement is entered into, and notify the CRA in prescribed form if the options granted are for non-qualifying securities subject to the new tax treatment, on or before the filing due-date for the taxation year of the employer or the issuer of the securities (if not the employer) that includes the date the agreement is entered into.

KPMG observations

The new stock option deduction rules significantly alter the tax treatment of stock options. Specifically, these rules may considerably increase the personal tax burden of certain executives and provide a corporate tax deduction that has not previously been available.

Affected companies may want to consider additional stock option grants before the rules come into effect, as well as any changes to their compensation plans going forward to maintain the maximum stock option deduction for employees under the new rules. For example, companies may wish to confirm that the vesting period stated in their stock option agreement allows options to vest over a number of years to benefit from the $200,000 annual cap, where possible. Companies should also establish appropriate tracking processes to differentiate between qualifying and non-qualifying options and check that deadlines for required notifications to the CRA and employees are met. Affected companies should also determine whether they want to designate additional stock options as non-qualifying (i.e., options below the $200,000 annual cap) to ease tracking requirements and provide for a corporate tax deduction. However, where a company makes such a decision, they should also consider the increased personal tax burden on affected employees.

Where the stock option agreement is entered into by a corporation or mutual fund trust that is not the individual's employer and does not deal at arm's length with the employer, the deduction is only available to the employer and not to the seller or issuer of the shares. In addition, where employee stock options are cash-settled, the employer may only be entitled to the corporate tax deduction where the underlying securities are subject to the new tax rules (i.e., are "non-qualifying" securities either because they exceed the $200,000 annual cap or were otherwise designated as non-qualifying). Where the securities continue to be subject to the existing tax treatment (i.e., are not "non-qualifying" securities), only the individual is entitled to the stock option deduction.

The new rules consider a common cross-border scenario, where an employee ceases to be a Canadian resident. Under the new rules, the company will need to track how much of the stock option benefit related to non-qualifying options is included in the employee's income for Canadian tax purposes to determine the amount that the company is eligible to deduct. However, there may be practical issues with the application of the rules, and in particular meeting the notification requirements, in other common cross-border scenarios that may arise. For example. where individuals become Canadian residents after the options are granted.

We can help

Your KPMG adviser can help you assess the effect of the stock option cap on your personal finances or business affairs, and point out ways to realize any benefits or ease their impact.