



GMS Flash Alert

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Canada - 2019 Budget Announces Cap on Employee Stock Option Grants

The Canadian government's budget for 2019 announced a cap to the use of the current employee stock option tax regime, for stock option plans of "large, long-established, mature" companies.¹

The measure in the budget leaves many questions in need of clarification; further details will be released in summer 2019. (For prior coverage of the budget, see [GMS Flash Alert 2019-057](#), March 27, 2019.)

WHY THIS MATTERS

This is a significant change in the tax treatment of stock options generally. It introduces a considerable increase in the personal tax burden of executives and opens the possibility of a corporate tax deduction that has not previously been available.

It will be important for companies to prepare for implementation of tracking and monitoring of their stock option grants and the application of the cap, as well as to establish how they differentiate the number of options eligible for the stock option deduction.

Current Rules

The current tax rules provide employee stock options with preferential personal tax treatment in the form of a deduction (the "stock option deduction") which effectively results in the employment income being taxed at rates similar to capital gains. The timing of taxation is generally at exercise or on disposition if the options are with respect to shares of a Canadian-controlled private corporation.

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The stock option deduction is not automatic and is subject to certain conditions. If the conditions are satisfied, this deduction applies to stock options, irrespective of the size and length of existence of the companies granting the options.

Budget 2019 Proposals

Budget 2019 proposes to apply a \$200,000 annual cap on employee stock option grants that may be eligible for the stock option deduction. (All dollar figures expressed are Canadian dollars.) The cap would be calculated by reference to the fair market value of the underlying shares on the date of grant. This would apply to employees of “large, long-established, mature” companies.

For “start-ups” and “rapidly growing” Canadian businesses, there would continue to be no cap with respect to the amount eligible for the stock option deduction.

For example, an executive of a “large, long-established, mature” company is granted stock options to acquire 100,000 shares of the employer at a price of \$50 per share, which is also the fair market value of the share on the date of grant. Since the fair market value of the underlying shares (\$5 million) exceeds the \$200,000 cap, the stock options that can receive preferential tax treatment will be capped. 4,000 options can continue to receive preferential tax treatment, while the stock option benefit associated with the remaining 96,000 options will be included in the individual’s income and taxed at full ordinary income rates and - important note in the Budget 2019 example - deductible for corporate income tax purposes.

At exercise, for shares that appreciated in value to \$70, the executive would include \$1,920,000 in ordinary income and only \$80,000 of the benefit would receive preferential personal income tax treatment. This would give rise to a difference of approximately \$1,000,000 in taxable income from the current rules.

The example in the 2019 federal budget announcement indicates that the proposed rules would also allow the company a corporate tax deduction (with respect to the portion of income corresponding to the options not eligible for the preferential personal tax treatment, i.e., the \$1,920,000 in the example) that is not available under the current rules.

Further details will be released in summer 2019 and any changes will apply on a go-forward basis only.

KPMG NOTE

The release of further details in summer 2019 is highly anticipated, as many aspects in this proposal require clarification, such as:

- 1 The meaning of “large, long-established, mature” and “start-up and rapidly growing” companies.
- 2 Whether, and how, this would impact the employees of Canadian subsidiaries of foreign corporations – is the test on Canadian companies only, or will it look at the parent as well?
- 3 What happens in case of significant growth of a company – is the test at grant, and will there be separate tracking of the options granted once the company is considered to have attained “large” status?
- 4 Will the corporate tax deduction now be available for all categories of stock awards – not just stock options – that are by design ineligible for the stock option deduction?

KPMG NOTE (cont'd)

Companies may wish to consider timing of granting stock options and other stock-based awards in anticipation of the additional details. Companies would need to be prepared to implement tracking and monitoring of the stock option grants and the application of the cap, with a view to differentiating the number of options eligible for the stock option deduction.

FOOTNOTE:

1 For the budget speech and related documentation, click [here](#).

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