Mobility: tax alert

April 2019

Canada

Federal budget 2019-20: proposed changes to the stock option deduction

On 19 March 2019, federal Finance Minister Bill Morneau tabled his fourth budget. The budget proposes significant changes to the tax treatment of employee stock options.

Executive summary
Where a corporation grants stock options with a fair market value exercise price to employees, paragraph 110(1)(d) of the *Income Tax Act* (the Act) provides a deduction equal to 50% of the benefit realized on the exercise or disposition of options where certain other conditions are satisfied. Budget 2019-20 proposes to limit the availability of the stock option deduction where options are granted to employees of "large, long-established, mature firms."

Specifically, except in the case of options granted by "start-ups and rapidly growing Canadian businesses" (for which no changes are proposed), the proposals seek to limit the 50% stock option deduction to an annual cap of $200,000 at the time of grant (based on the fair market value of the underlying shares).

If implemented, these proposals could significantly reduce the value of the stock option deduction for employees of public companies and other large, mature companies. Companies will need to track stock option grants that qualify for the stock option deduction, as this information will be needed for income tax withholding and reporting purposes. This tracking process could prove onerous where employees receive multiple stock option grants. Draft legislation to implement these proposals has not been released.

"Start-up and rapidly growing Canadian businesses"
As noted, no changes are proposed for employees who are granted stock options by "start-up or rapidly growing Canadian businesses." A number of decisions and value judgments will be required in order to define these terms with precision. This process may prove difficult and could lead to delay with respect to implementation.

Corporate deduction
The budget documents also contain a reference to a corporate tax deduction being available in circumstances where exercised options do not qualify for the stock option deduction. If this change is implemented, it would mark a significant revision to the longstanding Canadian position that generally prohibits a corporate deduction where an employer agrees to issue shares to employees. This change would provide a degree of symmetry, in that where an employee is fully taxable, the corporation should receive a deduction for the expense. This change would also bring the Canadian tax treatment of options closer to that of the US, where a corporate deduction is permitted for stock options when the employee does not qualify for preferential tax treatment.

The prospect of a corporate tax deduction raises a number of questions:

- If a corporate tax deduction is permitted, would it apply only to fair market value stock options, or to other forms of equity compensation such as restricted stock units (RSUs) and performance share units (PSUs)?

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- Arguably, if a corporate tax deduction is permitted for stock options, it should also apply to RSUs and PSUs, since the employee is already fully taxable on the value of the benefit. Many US companies agree to settle RSUs and PSUs in the form of shares.
- Would a corporate tax deduction be made available to Canadian subsidiaries of US firms for shares used to settle RSUs and PSUs?
- What would be the quantum of the deduction? Would Section 143.3 of the Act operate to deny all or a portion of any deduction on the basis that it is not an "expenditure?"
- The budget documents did not contain a discussion of the loss in tax revenue as a result of permitting a corporate deduction. It is possible that the government has not estimated the impact of permitting a deduction on federal finances.

Implementation

The budget documents note: "Any changes will apply on a go-forward basis only and would not apply to stock options granted prior to the announcement of the legislative proposals to implement any new regime."

- The existing rules should apply to stock options that have been granted, but have not yet been exercised.
- The use of the words "granted prior to the announcement of the legislative proposals" suggests that the existing rules should apply to any options granted before the announcement of the legislative proposals.
- Companies granting stock options to employees in the future may wish to consider accelerating grants so that they are issued prior to the announcement of the legislative proposals.
    - Budget 2019 states that further details will be released before the summer of 2019. As a result, time may be limited.

Implications

- The proposed changes arguably have less to do with tax expenditures and more to do with the perception of fairness, especially in light of the changes to the small business rules.
- The use of a monetary cap on the stock option deduction has some resemblance to the US stock option regime under which there are "nonqualifying" options which are taxable as ordinary employment income, and "incentive stock options" which can be taxed like long-term capital gains, subject to a dollar limit. The US generally permits a corporate tax deduction for nonqualifying options but not incentive stock options.
- The prevalence of stock option grants among large public companies has been in decline for several years owing primarily to corporate governance concerns. If these changes are implemented, they will likely lead to corresponding changes in the compensation mix, such as increasing the use of RSUs and PSUs instead of stock options.

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