Employee Stock Options: Changes Coming?

By Steve Suarez, Borden Ladner Gervais LLP (Toronto)

Many employers grant options to their employees to buy stock of the employer as a form of compensation. Employee stock options are favorably taxed under the Income Tax Act (Canada).

When a corporation grants an employee the right to buy its shares, the price at which the employee can buy the shares (the exercise price) is usually equal to the fair market value of the employee's shares at the date the option is granted. No taxable event occurs when the option is granted; instead, the taxable event is deferred until the option is exercised. If the underlying shares increase in value after the option is granted, the employee will typically exercise the option, pay the exercise price, acquire the shares, and enjoy a benefit equal to the difference between the value of the shares on the date of exercise and the exercise price (known as the in-the-money amount).

For tax purposes, the in-the-money amount is reported as a taxable benefit and included in the employee's income when the option is exercised. In most cases, the employee is entitled to deduct 50 per cent of the benefit in computing his taxable income under a deduction for qualifying stock options. Thus, the employee usually receives a benefit of which only half is taxable, such that the effective rate of tax is only 50 per cent of what it would otherwise be. This is sometimes referred to as "capital gains treatment," although this is not quite true. The taxable benefit is not a capital gain and so capital losses cannot be used against it. The employer cannot claim a deduction for any part of the value of the shares issued to the employee, and is required to effect normal payroll remittances on the taxable income arising from exercising the options even though the employee receives no cash.

In the recent federal election campaign, the Liberal Party of Canada included a commitment to limit the amount qualifying for the 50 per cent stock option deduction at $100,000 per year.

A starting point would be to set a cap on how much can be claimed through the stock option deduction. The Department of Finance estimates that 8,000 very high-income Canadians deduct an average of $400,000 from their taxable incomes via stock options. This represents three quarters of the fiscal impact of this deduction, which in total cost $750 million in 2014. Stock options are a useful compensation tool for start-up companies, and we would ensure that employees with up to $100,000 in annual stock option gains would not be affected by any new cap.

On November 20, 2015, Finance Minister Bill Morneau announced that any changes to the taxation of stock options would not be retroactive. Specifically, he told reporters, "I would like those Canadians who are concerned about this issue to understand that any decisions we take on stock options will affect stock options issued from that date forward." As such, there would not appear to be any need to act on existing stock options, although it may be desirable for employers to accelerate the issuance of new options ahead of the next federal budget.

The estimated fiscal impact of capping the 50 per cent stock option deduction would not seem to take into account the possibility that employers may shift into different forms of compensation. In fact, one study suggested that as employers respond by moving to tax-deductible forms of executive compensation, restricting the 50 per cent stock option deduction might actually cost the government money. Mining companies should watch for further developments on this issue.

Steve Suarez is a partner in the Toronto office of Borden Ladner Gervais LLP. He can be reached at (416) 367-6702, ssuarez@blg.com or at www.miningtaxcanada.com.

References
1. If the employee acquires shares of a "Canadian controlled private corporation" (CCPC), the taxable benefit is not included in the employee's income until the shares acquired by exercising the option are sold.
2. Basically, the 50 per cent stock option benefit is applicable either where (1) the shares acquired under the option are ordinary common shares and the options were not "in the money" when granted, or (2) the shares are shares of a CCPC that are held for at least two years.
3. Where the stock option is surrendered for a cash payment instead of being exercised, the employer must agree to forgive any deduction for the payment in order for the employee to be able to claim the 50 per cent stock option deduction.

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