KPMG

GMS Flash Alert

Global Compensation Edition

2019-125 | July 19, 2019

Canada – New Developments on Proposed Cap on Employee Stock Option Deduction

Canada's Department of Finance has released new legislative proposals to institute a $200,000 annual cap for certain employee stock options that qualify for the stock option deduction *granted on or after* January 1, 2020.[1] (All dollar figures expressed are Canadian dollars.)

The Department of Finance has also clarified that stock options granted by Canadian-controlled private corporations (CCPCs) and certain "highly innovative, fast-growing companies" will be exempted from the new limit, and is seeking comments from stakeholders on the criteria that these companies must meet to be excluded. Comments on this issue are due by September 16, 2019.[2]

For the full report, see "Finance Reveals More Details on Stock Option Deduction Cap," in *TaxNewsFlash-Canada* (2019-29, June 19, 2019), a publication of the KPMG International member firm in Canada.

For additional background, see our earlier report in GMS *Flash Alert* 2019-058 (March 27, 2019).

WHY THIS MATTERS

These new legislative proposals provide for a significant change in the tax treatment of stock options. Specifically, the proposals considerably increase the personal tax burden of certain executives, and provide a corporate tax deduction that has not previously been available to Canadian employers for stock-settled options.

Under the new proposed rules, employers will (1) have to notify employees in writing whether the stock options granted are subject to the annual cap, and (2) notify the Canada Revenue Agency (CRA) if they issue securities subject to the new rules by filing a prescribed form with their tax return for the taxation year in which the option was granted.

Detailed Considerations

Application of Annual Limit

- The proposed legislation stipulates that the $200,000 annual limit on the value of employee stock options that may vest in any calendar year will generally apply 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.

- The $200,000 annual limit is calculated based on the aggregate fair market value of the shares at the date of option *grant*. This limit is calculated per grant and cannot be carried forward if unused (please see the example below).

- Where an individual has two or more employers who deal at arm's length with each other, that individual would have a separate $200,000 annual limit for each of those employers, according to Finance.

- The proposed legislation also clarifies that where the value of stock options that may vest in a year exceeds the $200,000 annual limit, the employee stock options that are granted first will be the first to qualify for the stock option deduction, i.e., analogous to a "first-in first-out" approach.

- Where an employee has a number of identical stock options and some qualify for the existing treatment while others are subject to the new rules, the employee will be considered to exercise the stock options qualifying for the existing treatment first. Employers subject to the new rules will be able to designate which employee stock options are subject to the current tax treatment, up to the $200,000 annual limit per employee, and which are subject to the current tax treatment but will be designated as being subject to the new rules.

New Employer Compliance Requirements

- Employers will have to notify employees in writing whether options are subject to the annual cap when the stock options are granted; and

- Notify the CRA if they issue securities subject to the new rules by filing a prescribed form with their tax return for the taxation year in which the option was granted.

Availability of Corporate Tax Deduction

Where, as a result of these new rules, the employee is *not* entitled to the stock option deduction, the proposed legislation allows qualifying employers to claim a corporate tax deduction that equals the employee's stock option benefit. To qualify, the employer must:

- be a specified person (i.e., not a CCPC or otherwise excluded under certain conditions that have not yet been determined);

- have employed the individual at the time the agreement was entered into; and

- meet the notification requirements (referred to above under New Employer Compliance Requirements).

Where these conditions are met, employers can claim a corporate tax deduction for agreements to sell or issue securities that are entered into after 2019.

Example

Finance has outlined several examples of how the proposed rules will work. Assume that, in 2020, an individual is granted stock options as follows:

- 200,000 shares at a price of $50 per share (the fair market value of a share on the date the options are granted).
- 25% of the options vest in each of 2021, 2022, 2023, and 2024.
- $50 × 50,000* = **$2.5 million** (*25% of the shares over four years: 2021, 2022, 2023, 2024).
- Since the fair market value of the underlying shares at the time of grant in each vesting year ($2.5 million) **exceeds the $200,000 annual limit**, the number of stock options that can receive preferential tax treatment will be capped.
- Thus only 4,000 of the options in each vesting year can receive preferential personal tax treatment ($200,000 / $50).
- However the remaining 46,000 options in each vesting year will be fully taxable and includable in the individual's income and fully taxed at ordinary rates, and therefore be deductible to the employer for corporate income tax purposes. In summary:
    - 4,000 shares ($200,000 / $50) in each vesting year = Not subject to cap, can receive preferential income tax treatment
    - 46,000 shares (50,000 – 4,000) in each vesting year = Subject to cap, includible in income, taxed at ordinary rates.

Then, if the individual exercises all of these options in 2024, at which time the price of the shares has increased to $70, then $3.68 million (($70 - $50) x 184,000) will be fully taxed at ordinary rates (with a deduction to the employer), while only $320,000 (($70 - $50) × 16,000) may be eligible to receive preferential personal income tax treatment resulting in a 50-percent deduction of the stock option benefit (with no deduction to the employer).

KPMG NOTE

The proposed legislation was introduced as a Notice of Ways and Means Motion to Parliament and is not yet in the form of a tax bill. Parliament commenced its summer recess, so this legislation will not pass as a tax bill until later this summer. Furthermore, since the consultation period for this legislation ends September 16, 2019, it is unlikely that further details on these important definitions will be determined before late summer or early fall of 2019.

Affected companies may want to consider the following in readiness for January 2020:

- Additional stock option grants prior to the effective date of the new rules,
- Amend Plans to maintain the maximum stock option deduction for employees under the new rules, such as allowing options to vest over a number of years to benefit from the $200,000 annual cap, where possible.
- Develop internal processes for tracking several tranches of stock options qualifying for the differentiated tax treatment, and attaining readiness for the new compliance requirements regarding grant reporting.
- Assess how to update the tax withholding rates for stock options going forward with your stock plan administrators. This will need to tie in with the tracking approach that is developed.

FOOTNOTES:

1 See the June 17, 2019 Department of Finance News Release "Government of Canada to Make Tax System Fairer, Launches Consultations on Stock Options." Readers can also find at that link, the related Notice of Ways and Means Motion and a Department of Finance "Backgrounder."

2 Ibid.

* * * *

C$1 = US$ 0.765
C$1 = £0.61
C$1 = €0.68
C$1 = ¥82.365

This article is excerpted, with permission, from "Finance Reveals More Details on Stock Option Deduction Cap," in *TaxNewsFlash-Canada* (2019-29, June 19, 2019), a publication of the KPMG International member firm in Canada.

Contact us

For additional information or assistance, please contact your local GMS or People Services professional or the following professional with the KPMG International member firm in Canada:

Ana-Luiza Georgescu
Tel. +1-514840-2538
algeorgescu@kpmg.ca

The information contained in this newsletter was submitted by the KPMG International member firm in Canada.

www.kpmg.com

kpmg.com/socialmedia

Flash Alert is a GMS publication of KPMG LLP's Washington National Tax practice. To view this publication or recent prior issues online, please click here. To learn more about our GMS practice, please visit us on the Internet: click here or go to http://www.kpmg.com.