JULY 22, 2021 • 1 MIN READ

Employee stock options: Changes to tax treatment now in force

AUTHORS


Gwen Watson


Richard W. Johnson


Jennifer Lennon


Christophe Cinqmars-Viau

The amendments to the *Income Tax Act* (Canada) (Tax Act) that restrict the amount that employees are entitled to deduct in respect of stock option benefits (Stock Option Rules) for employee stock options granted on or after July 1, 2021 have now been enacted as part of Bill C-30, *An Act to implement certain provisions of the budget tabled in Parliament on April 19, 2021 and other measures* (Bill C-30). In this bulletin, we discuss the new Stock Option Rules.

What you need to know

- The Stock Option Rules cap the availability of the 50% employee deduction (50% Deduction) for certain stock option benefits based upon a $200,000 annual vesting limit. In addition, employers can designate certain stock options as ineligible for the 50% Deduction.
- The Stock Option Rules apply to employee stock options granted by employers that have annual gross revenue in excess of $500 million or by employers that are members of a group that prepares consolidated group financial statements where the annual total consolidated group revenue exceeds $500 million.
- However, the Stock Option Rules generally do not apply to employers that are Canadian-controlled private corporations (CCPCs).
- The Stock Option Rules permit the employer to deduct amounts in respect of employee stock option benefits where the stock options are ineligible for the 50% Deduction.
- The Stock Option Rules apply in respect of employee stock options granted on or after July 1, 2021.
- Employers will need to comply with onerous tracking, administration, and notification requirements in connection with their stock option grants.

Introduction

The Stock Option Rules were enacted as part of Bill C-30 on June 29, 2021 and generally take effect for employee stock options granted on or after July 1, 2021.

The Stock Option Rules generally restrict the 50% Deduction that may otherwise be available to the employee on the exercise or cash out of employee stock options for securities that are non-qualified securities for the purposes of the Stock Option Rules. The underlying securities are deemed to be non-qualified securities if the $200,000 Annual Vesting Limit is exceeded. The underlying securities can also be designated as non-qualified securities by the grantor if certain conditions are met.

Where the employee is denied the 50% Deduction because the underlying securities are non-qualified securities, the employer is generally eligible to deduct the amount of the stock option benefit if certain conditions are met.

The Stock Option Rules generally apply to employee stock options granted by employers that have annual gross revenue in excess of $500 million or by employers that are members of a group that prepares consolidated group financial statements where the annual total consolidated group revenue exceeds $500 million.

Employee stock options granted by CCPCs are generally not subject to the Stock Option Rules. However, as described in more detail below, there are certain situations where employee stock options granted by CCPCs may be affected.

With the enactment of the Stock Option Rules, employers now need to comply with onerous tracking, administration and notification requirements in connection with their stock options granted on or after July 1, 2021. Both employers and employees should consider the implications of these new measures on their long-term compensation arrangements.

We provide a detailed discussion regarding the application of the Stock Option Rules from the perspective of both employees and employers below.

1. Limit on employee deduction

The Stock Option Rules deny the 50% Deduction for stock option benefits realized in respect of the exercise of employee stock options to acquire non-qualified securities. Generally, stock options will be subject to the Stock Option Rules if the following three conditions are satisfied:

- the stock options are granted by an employer that is a “specified person”;
- the underlying securities are “non-qualified securities”; and
- the stock options are granted on or after July 1, 2021.

Under the Stock Option Rules, employers have an obligation to notify the employee and the Canada Revenue Agency (CRA) if the securities underlying a stock option are non-qualified securities.

(A) Employers who are specified persons

The Stock Option Rules apply to employee stock options granted by an employer that is a “specified person” as defined in the Stock Option Rules.

For these purposes, a “specified person” is a “qualifying person” (which is defined to mean a corporation or a mutual fund trust) that is not a CCPC and:

a. where the qualifying person is a member of a group that annually prepares “consolidated financial statements”[1], the total annual consolidated group revenue reflected in the last consolidated group financial statements presented to shareholders or unitholders of the ultimate parent entity for the group prior to the stock option grant exceeds $500 million; or

b. in any other case, the qualifying person has annual gross revenue in excess of $500 million based on the amounts reflected in its annual financial statements presented to shareholders or unitholders for its last fiscal period preceding the stock option grant, or its second to last fiscal period preceding the stock option grant if financial statements have not been presented to shareholders or unitholders for its last fiscal period, or, where financial statements were not presented to shareholders or unitholders for either of those periods, the amounts that would be reflected in annual financial statements for its last fiscal period if such statements had been prepared in accordance with generally accepted accounting principles.

The exclusion for CCPCs from the definition of "specified person" means that the Stock Option Rules should generally not apply to stock options granted by CCPCs.

However, there are some circumstances where the Stock Option Rules can apply to stock options granted by CCPCs. For example, the Stock Option Rules will apply to stock options granted by a CCPC to an employee of the CCPC where the underlying securities are securities of another qualifying person that does not deal at arm's length with the CCPC and the other qualifying person is a "specified person". Similarly, the Stock Option Rules can apply to stock options granted by a CCPC to an employee of another qualifying person that does not deal at arm's length with the CCPC and the other qualifying person is a "specified person". These situations may be rare, but it is important to recognize that CCPCs are not completely excluded from the application of the Stock Option Rules.

The total annual consolidated group revenue or annual gross revenue tests are a proxy for and address some of the uncertainty surrounding what the Government considers to be large, long-established, mature companies that the Government indicated would be targeted in its initial announcement of these rules.

(B) Non-qualified securities

Securities underlying employee stock options granted by specified persons will be "non-qualified securities" to the extent that the Annual Vesting Limit is exceeded or if the qualifying person designates the underlying securities to be non-qualified securities in accordance with the Stock Option Rules.

(i) Annual Vesting Limit

The Annual Vesting Limit will apply to an employee stock option where the following three conditions are met (Conditions of Application):

i. the grantor (a qualifying person) grants an option over the grantor's securities (or of another qualifying person with which the grantor does not deal at arm's length) to the employee;

ii. at the time the stock option is granted (referred to as the relevant time), the employee is an employee of the grantor or of another qualifying person that does not deal at arm's length with the grantor; and

iii. any of the following persons are specified persons at the relevant time: a) the grantor, b) the other qualifying person referred to in i) above, or c) the employer.

Where the foregoing Conditions of Application are met, the proportion of the underlying securities to be issued under the employee stock option that are deemed to be non-qualified securities is determined by the formula A/B.

Variable A is itself determined by the formula C + D - $200,000.

Variable B is the amount that is determined for C above.

Variable C is the total of all amounts each of which is the fair market value of a security to be issued under the stock option (determined as at the grant date of the stock option) that has the same vesting year.

Variable D is the lesser of (i) $200,000 and (ii) the total of all amounts each of which is the fair market value of a security underlying other stock options having the same vesting year that are granted to the employee by the grantor or by a qualifying person that does not deal at arm's length with the grantor, other than: (a) securities designated as non-qualified securities pursuant to the Stock Option Rules, (b) securities that are "old securities" (within the meaning of subsection 7(1.4) of the Tax Act) with respect to an exchange of stock options to which subsection 7(1.4) applies, (c) securities where the right to acquire those securities is an "old right" (within the meaning of subsection 110(1.7) of the Tax Act) with respect to a reduction in the exercise price of the related stock option to which subsection 110(1.7) applies, and (d) securities in respect of which (A) the related stock option has expired, or has been cancelled, before the relevant time, and (B) the 50% Deduction is not available to the employee for any year.

For these purposes, the "vesting year" is the calendar year specified in the stock option in which the stock option first becomes exercisable (other than as a consequence of an event that is not reasonably foreseeable at the time the stock option is granted). However, if the stock option does not specify the vesting year, then the vesting year is the calendar year in which the option would become exercisable if the option specified that all identical rights to acquire the underlying securities become exercisable on a pro rata basis over the period that begins on the day the stock option is granted and ends on the earlier of: a) the day that is 60 months after the date of grant, and b) the last day that the stock option could be exercised.

The Technical Notes provide an illustrative example of the vesting year for a stock option that is granted on July 1, 2022 and expires on June 30, 2029 (i.e., a seven-year period) and does not specify the year(s) in which the rights to acquire the underlying securities may first be exercised. In that case, 10% of the securities would have a vesting year of 2022, 20% would have a vesting year of 2023, 20% would have a vesting year of 2024, 20% would have a vesting year of 2025, 20% would have a vesting year of 2026, and 10% would have a vesting year of 2027. The rule for determining the vesting year for stock options that do not have a specific time when they become exercisable addresses this uncertainty in the Government's initial announcement of the Stock Option Rules.

It should be noted that the vesting year of an underlying security is determined at the time the stock option is granted and may be different from the year in which the stock option is exercised.

The following example from the Technical Notes illustrates the application of the Annual Vesting Limit.

Example:

Mckayla is an employee of Xco, which is a specified person. In 2022, Xco agrees to grant her 70,000 employee stock options to acquire 70,000 shares of Xco, each with a strike price of $2 (the fair market value of the underlying securities at the time the options are granted). The first year Mckayla will be able to acquire those securities is in the 2024 calendar year.

The proportion of those securities that are deemed to be non-qualified securities is:

A/B

A = C + D - $200,000

where

C = $140,000 (i.e., 70,000 x $2)

D = is the lesser of

(i) $200,000; and

(ii) 0

A = 0 (i.e., $140,000 + 0 - $200,000)

B = $140,000

A/B = $0/$140,000

As a result, none of the securities in respect of which options are granted in 2022 are non-qualified securities.

In 2023, Xco agrees to grant Mckayla another 50,000 options to acquire 50,000 shares of Xco with a strike price of $2 (the fair market value of the underlying securities at the time the options are granted) with a vesting year of 2024.

The proportion of those securities that are deemed to be non-qualified securities is:

A/B

A = C + D - $200,000

where

C = $100,000 (i.e., 50,000 x $2)

D = is the lesser

(i) of $200,000; and

(ii) $140,000 (i.e., the amount for C for the previous options with the same vesting year)

A = $40,000 (i.e., $100,000 + $140,000 - $200,000)

B = $100,000

A/B = $40,000/$100,000

As a result, 20,000 (i.e., 50,000 x ($40,000/$100,000)) of the 50,000 securities in respect of which options are granted in 2023 are non-qualified securities.

To the extent that the underlying securities are non-qualified securities as a result of the Annual Vesting Limit, the employee is disqualified from claiming the 50% Deduction on the exercise of stock options in respect of such non-qualified securities. However, as discussed further in Part 2 below, the employer is eligible to deduct an amount in respect of the stock option benefit in respect of such non-qualified securities.

(ii) Ordering rules

The Stock Option Rules provide two different ordering rules to assist in the determination of non-qualified securities under the Annual Vesting Limit.

The first ordering rule provides that if the employee acquires underlying securities on the exercise of a stock option and the acquired securities could be securities that are not non-qualified securities, then the securities are deemed to not be non-qualified securities. According to the Technical Notes, this ordering rule is intended to address circumstances where an employee exercises stock options to acquire some but not all of the underlying securities that the employee could acquire under the stock options (i.e., a partial exercise), and the acquired securities may or may not be non-qualified securities. This ordering rule deems the employee to have acquired the securities that are not non-qualified securities before acquiring any securities that are non-qualified securities.

The following example from the Technical Notes is illustrative:

Example:

Andrew is an employee of Yco, a specified person. In 2022, Yco grants Andrew options to acquire 300,000 shares with a strike price of $2 per share (the fair market value of the underlying securities at the time the options are granted) and a vesting year of 2023. Yco does not agree to sell Andrew any other securities with that vesting year.

Under subsection 110(1.31), 200,000 of those shares will be non-qualified securities and 100,000 of the shares will be qualified securities.

If Andrew chooses to exercise his right to acquire 150,000 of those 300,000 shares in 2023, 100,000 of those shares could be qualified securities. Thus, he is considered to exercise options to acquire the 100,000 qualified securities first, with the remaining 50,000 shares being non-qualified securities.

The second ordering rule addresses the ordering of multiple stock option grants at the same time. This rule provides that where two or more stock options are granted by a qualifying person at the same time and the qualifying person designates the order of the grants, then for the purposes of variable D of the Annual Vesting Limit discussed above, the stock options are deemed to be granted in the order so designated. According to the Technical Notes, this ordering rule is intended to ensure that one stock option agreement does not preclude another from granting securities that are not non-qualified securities[2].

(iii) Designation as non-qualified securities

Apart from the Annual Vesting Limit, the underlying securities will be non-qualified securities if the grantor designates the underlying securities to be non-qualified securities. In order for the grantor to be able to make the designation, the Conditions of Application for the Annual Vesting Limit (discussed above) must be met. Where the grantor designates the underlying securities as non-qualified securities, the underlying securities are deemed to be non-qualified securities. Such a designation disqualifies the employee from claiming the 50% Deduction on the exercise of the stock options in respect of such securities. However, as discussed in further detail in Part 2 below, the employer is eligible to deduct an amount in respect of the stock option benefit in respect of such non-qualified securities.

(iv) Notification of non-qualified securities

Where the securities underlying a stock option are non-qualified securities (either because the Annual Vesting Limit has been exceeded or because of the designation of the securities as such), the employer of the employee (which may not be the grantor) is required to notify the employee and the CRA that the underlying securities are non-qualified securities. The employer is required to notify the employee in writing of the non-qualified securities within 30 days after the date on which the stock option was granted. The employer is required to notify the CRA, in prescribed form, that the security is a non-qualified security on or before the grantor's filing due date for the taxation year in which the stock option was granted.

(C) Stock options granter on or after July 1, 2021

The Stock Option Rules apply to employee stock options granted on or after July 1, 2021. Stock options granted before July 1, 2021 which vest after June 30, 2021 will not be included in the calculation of the Annual Vesting Limit. In addition, where, after June 30, 2021, an employee exchanges stock options which were granted before July 1, 2021 for new stock options, the new stock options will also be excluded from the calculation of the Annual Vesting Limit, provided the existing requirements under the Tax Act for tax-deferred stock option exchanges under subsection 7(1.4) of the Tax Act are satisfied in respect of such exchange.

2. New employer deduction

Historically, employers have not been entitled to claim a deduction in respect of stock option benefits realized upon the exercise of stock options. However, if certain conditions are met, the Stock Option Rules permit an employer to deduct in computing its taxable income for a taxation year an amount equal to the amount of the stock option benefit in respect of employment with the employer that is deemed under subsection 7(1) of the Tax Act to have been received by an employee in the year in respect of the exercise of an employee stock option for a non-qualified security granted by the employer (or a qualifying person that does not deal at arm's length with the employer) to an employee.

The conditions that must be met are the following:

i. the employer is a qualifying person;

ii. the employee was an employee of the employer at the time the stock option was granted;

iii. the amount is not claimed as a deduction in computing the taxable income of another qualifying person;

iv. the 50% Deduction would have been available to the employee if the security was not a non-qualified security;

v. if the employee is not resident in Canada throughout the year, the stock option benefit must be included in computing the employee's taxable income earned in Canada for the year; and

vi. the employer must comply with the notification requirements (as discussed in Part 1 above) in respect of the non-qualified security.

The employer deduction is available in respect of the exercise of employee stock options over non-qualified securities regardless of whether the securities are non-qualified securities because the Annual Vesting Limit is exceeded or because the securities have been designated as non-qualified securities. This means that employers can choose to designate the securities underlying an employee stock option as non-qualified securities in order for the employer to be able to deduct amounts in respect of the stock option benefit realized by the employee (where the conditions for the employer deduction described above are satisfied).

3. Consequential changes to the cash out of employee stock options

The Stock Option Rules also contain consequential amendments to the rules applicable on the cash out of employee stock options.

First, the Stock Option Rules provide a specific rule with respect to the cash out of employee stock options where the underlying securities are not non-qualified securities. This rule applies where: i) the Conditions of Application for the Annual Vesting Limit are met (as discussed above in "1. Limit on employee deduction"), ii) the underlying securities are not non-qualified securities, and iii) a payment is made to the employee for the transfer or disposition of a stock option (i.e., a cash out). Where this rule applies, the employee is eligible for the 50% Deduction in respect of the cash out and, as discussed in more detail below, no qualifying person is entitled to any deduction in respect of the cash out payment[3]. Prior to the enactment of the Stock Option Rules, in order for the employee to be eligible for the 50% Deduction on a cash out of employee stock options, the grantor had to make the election under subsection 110(1.1) to forgo the deduction by the grantor (or any non-arm's length persons) in respect of the cash out payment (other than for a designated amount). Whereas under the Stock Option Rules, on a cash out of employee stock options over securities that are not non-qualified securities to which this rule applies, the 50% Deduction is automatic; it is not dependent on the grantor making the subsection 110(1.1) election.

Second, another rule affecting the subsection 110(1.1) election applies where the grantor designates securities underlying an employee stock option as non-qualified securities. Where such a designation is made, the grantor is precluded from making the election under subsection 110(1.1) with respect to the deduction of the cash out payment. As a result, where a grantor designates the underlying securities as non-qualified securities, the employer is eligible for the employer deduction in respect of the stock option benefit, the employee is ineligible for the 50% Deduction and the employer cannot then shift the 50% Deduction back to the employee on a cash out of the stock options by making the subsection 110(1.1) election.

4. Other considerations

(A) Compensation adjustments

Employers that are impacted by the new Stock Option Rules should consider exploring whether these changes merit any adjustment to their compensation arrangements. Possibilities include restructuring compensation arrangements for employees who are negatively impacted by the new measures, structuring stock option grants to ensure that the underlying securities are not non-qualified securities (or, if the employer deduction is desired, to ensure that the underlying securities are non-qualified securities), or transitioning towards other share-based compensation arrangements, such as restricted share units or performance share units.

(B) Notifications and internal practices

Employers should take this opportunity to review their internal administrative practices with respect to stock option grants. The new measures will require employers to track stock options granted by them and related corporations in respect of non-qualified securities and to comply with the prescribed notification requirements.

---

[1] As defined in subsection 238.1(1) of the Tax Act.

[2] We note that subsection 110(1.42) as enacted in Bill C-30 states "If two or more agreements to sell or issue *options* are entered into at the same time…" (emphasis added) It is not clear whether the reference to "options" is intended say "securities", which would be more consistent with the context of these rules. If it is meant to refer to "options" then this rule may have limited impact as it is not typical for employers to sell or issue options to sell or issue securities to employees.

[3] Other than a deduction for a "designated amount" as defined in subsection 110(1.2) with respect to certain employee stock option hedging arrangements.

To discuss these issues, please contact the author(s).