

Proposed changes to tax rules on stock options

January 6, 2016

Author

Éric Gélinas

Counsel and Lawyer

The election of a majority Liberal government last October 19 signaled that there would be numerous changes to Canadian tax policy, particularly for individuals. One of these changes which has made waves in the business community is the reform of the tax regime applicable to stock options.

Under section 7 of the *Income Tax Act* (Canada) in its current form, the benefit realized by an employee on exercising stock options is treated as employment income. However, in most cases, the employee can claim a deduction equal to 50% of this benefit, meaning, from an economic standpoint, that the employee benefits from similar treatment to capital gains on this taxable benefit.

As a general rule, the taxable benefit on stock options is taxed at the same time as the option is exercised, i.e. when the shares are acquired. However, the taxation is delayed until the shares are disposed of, where the corporation that issued the options was a "Canadian-controlled private corporation" at the time the stock-option plan took effect.

The stock-option deduction granted to employees, which cost the federal government \$750 million in 2014 according to the projections of the Department of Finance, was targeted by the Liberal Party because it considers that the deduction disproportionately favours high-income taxpayers. Moreover, the announced changes in this regard are aimed at increasing the federal government's revenues in order to finance a reduction in the tax burden of the middle class.

In their electoral platform, the Liberals stated that they intended to increase the tax on benefits from stock options issued to employees by setting a cap on the applicable deduction. However, in the same breath, they acknowledged that stock options are a useful compensation tool for start-up businesses. Therefore, employees that receive stock-option benefits of \$100,000 or less per year will not be affected by the new cap.

On the other hand, the Liberal program makes no distinction between options issued by public corporations and those issued by Canadian-controlled private corporations. Also, no details were provided on when this reform would come into force nor on the transitional measures that would apply to options that have already been issued. This uncertainty prompted some people to advise stock-option holders to exercise them as soon as possible to avoid the new unfavourable rules that

could apply as soon as they are announced.

The new federal Minister of Finance, the Honourable Bill Morneau, elaborated on the government's intentions in this regard during a press conference held at the time the *Update of Economic and Fiscal Projections* was presented on November 20, 2015

The Minister indicated that he would continue his reflection on the tax treatment of stock options in the coming months, but provided an important clarification: any change will only apply to options issued on or after the date the decision is announced. Consequently, any option issued prior to that date will receive the current tax treatment. Mr. Morneau stated during the press conference that he wished to dispel any uncertainty and avert any hasty decision making by certain taxpayers.

While these statements should be welcomed, some uncertainty remains on the precise amendments that will be made to the tax treatment of stock options. Given the statement by the Minister of Finance last November 20 that it is not necessary for stock-option holders to rush the exercise of their stock options in order to avoid the application of new less advantageous rules, it would be preferable for taxpayers to make reasoned decisions in this regard based on their tax situation as a whole and other expected legislative changes, such as the addition of a 33% tax bracket on taxable income exceeding \$200,000.

Bill C-2, which Minister Morneau tabled before the House of Commons on December 9, 2015, does not deal with the reform of the tax regime for stock options. That reform will possibly be announced in the 2016-2017 budget, which will be made public in the early months of 2016. In the meantime, opponents of these amendments will certainly make their voices heard, such as start-up companies, which do not often have the means to offer competitive salaries and that rely on a stock-option plan to attract and retain key employees.

In this context, companies that have set up stock-option plans for their employees would be well advised to review them and ensure that their compensation policies remain adequate and competitive in light of the anticipated changes to the tax treatment of such options.