Anticipated Stock Option Changes — Government Announces Grandfathering

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At a press conference today Finance Minister Bill Morneau said that the new federal government will provide grandfathering for existing stock options as part of its campaign promise to cap the amount that is eligible for the 50% stock option deduction. At the press conference about Canada's Economic and Fiscal Update, the Minister said that the potential measure on stock options will only take effect once the changes have been announced.

The Finance Minister said that the government will be reviewing the stock option measures in the next few months. Although the full details of the new stock option regime are not currently known, many affected taxpayers have been wondering whether they should exercise their stock options now and what that would mean for them. Although today's announcement indicated that stock options issued before changes are announced will be grandfathered, the federal top marginal tax rate is still expected to increase by 4% in 2016 and as such taxpayers could save 2% federal tax by exercising in 2015. Each stock option plan and situation is unique, so it is important that you understand the variables that should be considered in making any decisions about stock options.

Background — Tax treatment of stock options

A stock option plan usually gives an employee of a corporation the right to purchase shares of the corporation at a given exercise price. This exercise price may be above or below the market price of the shares at the time the option is granted.

When the employee exercises the stock option and acquires shares, the difference between the price the employee pays for the shares and their market value is treated as a taxable benefit to the employee under paragraph 7(1)(a).

If certain conditions are met, the employee can claim a deduction of one-half of the taxable benefit under paragraph 110(1)(d) or 110(1)(d.1), effectively taxing the employment benefit at the same rate as a capital gain.

Public company employees may generally qualify for the 50% paragraph 110(1)(d) stock option deduction if all of these conditions are satisfied:

- The shares are normal common shares (not preferred shares)

- The exercise price is at least equal to the fair market value of the shares at the time the option was granted
- The employee deals at arm's length with the corporation.

Stock options in Canadian controlled private corporations (CCPCs) are treated differently. As long as the employees deal at arm's length with the corporation, under subsection 7(1.1) the taxable benefit is reported when the employees sell the stock option shares, rather than when they exercise their options and acquire the shares. The 50% stock option deduction under paragraph 110(1)(d.1) is available in the year the benefit is included in income, if the employee holds the CCPC shares for at least two years.

Potential capping of stock option deduction

The Liberal party's election platform states that a Liberal government would "set a cap on how much can be claimed through the stock option deduction". However, "employees with up to $100,000 in annual stock option gains will be unaffected by any new cap". The platform gives no further details or any indication of when such a measure would be effective.

According to media reports, government house leader Dominic LeBlanc said implementing new measures to change personal income tax rates will be brought in as a top priority so that these measures can be in place for January 1, 2016. The changes to personal income tax rates are expected to include a 4% increase to the federal tax rate for income over $200,000. This translates into a 2% federal tax rate increase for a stock option benefit when the 50% stock option deduction is claimed. Following this increase, combined federal and provincial tax rates for income over $200,000 will range from 47% to 59%, depending on the province. As a result, the top federal and provincial tax rate on stock option benefits will double to 47%-59% when the stock option deduction is limited (instead of the 24%-27% rate applicable when the stock option deduction is claimed).

Finance may also want to consider whether to allow employers a deduction for the amount of the stock option benefit that would no longer qualify for the stock option deduction under a new cap regime. Currently, employers cannot deduct benefits received by employees under stock option plans, unlike cash compensation.

What are the choices for stock option holders and their employers?

Stock option holders are facing an increase in the top marginal tax rate for income over $200,000 (probably effective January 1, 2016) and a cap on the amount they can claim for the stock option deduction. As a result, any stock option benefit over the cap would be taxed at full rates instead of capital gains rates when the new stock option regime becomes effective.

To help inform you about the federal tax implications of choices you may consider in anticipation of these changes, we have summarized some possible choices and their key federal tax implications. Quebec's tax treatment of stock options is outside the scope of this article.

Public company stock options

Employees who hold public company stock options may choose to exercise their options in 2015, before the federal top tax rate increases in 2016, to realize the 2% federal tax savings. These options should remain eligible for the 50% stock option deduction, provided they were granted before the date the new stock option regime becomes effective.

These employees should keep in mind that they may effectively be pre-paying tax that could have been deferred by exercising the options in 2016 or later. Whether to exercise options and pre-pay tax should be analyzed on a case-by-case basis, and should consider the number of years remaining to exercise the options under the terms of the plan, the employee's tax bracket and the growth expectations for the value of the shares.

Once the options are exercised, the employees may either hold or sell the shares. In some cases, employees may choose to cash out the options or sell the options themselves. Implications of these choices are discussed below.

Exercise options and hold shares

If employees choose to exercise public company stock options to take advantage of the potential 2% federal tax savings and hold the shares rather than sell them, they should keep the following points in mind:

Risk of capital losses – It’s important to note that if the shares decline in value such that there is a capital loss when they are sold, employees will not be able to offset the capital loss against the taxable employment benefit.

Payment of withholding tax - Subject to grandfathering and other exceptions, public company employers will have to withhold tax on the employment benefit (net of the stock option deduction) when employees exercise their options. As a result, the tax will be due right away and cannot be deferred to the time the employee's tax return is filed. Employees may therefore need to sell some shares to obtain the cash to pay the tax. Many agreements do not afford employers the right to sell their employees' shares, so mutual agreements may be required. Employers should note that they may be subject to penalties if they do not withhold and remit the tax on the net stock option benefit.

Exercise options and sell shares

Employees may choose to exercise stock options before January 1, 2016 and sell the shares immediately. However, they may be giving up future growth in the shares' value if they do so.

Cash out the options

If a cash-out right is included in a stock option plan, employees may choose to use it to receive cash from their employer instead of shares. If a cash-out right is not included in the stock option plan, it may be possible to revise the plan to include one. However, employers need to consider whether they can claim a deduction for the cash-out amounts paid to employees under such a plan.

Considerations for employers

Employers who offer stock option plans to their employees may want to consider the following issues.

Accelerate granting of options

Employers may want to consider granting options now before the new stock option regime becomes effective to take advantage of grandfathering rules.

Consider other forms of compensation

Employers may consider other forms of employee compensation such as a deferred share unit (DSU) plan (or sometimes referred to as phantom stock plan) or performance stock unit (PSU) plan. However, these plans don't allow employees to choose the timing for triggering the taxable benefit.

Potential employer deductions

Currently, benefits received by employees under stock option plans cannot be deducted by the employer in computing its taxable income, unlike cash compensation. It is unclear whether the new government intends to allow the employer a deduction where the proposed stock option deduction cap applies to give employers the same deduction that is allowed for other forms of compensation. If it does not, it may make stock options a more expensive form of compensation compared to many others.

Impact on financial statements

Employers need to consider the implications for their financial statements of any actions they take to change their stock option plans.

Changing terms of stock options plans

Before making any changes to the terms of employee stock option plans, employers should consider the existing terms of the plans and get legal advice about the implications of changing them. Vesting rights may need to be altered and controls over the exercised shares considered.

CCPC stock options

It is not clear whether the new Liberal government intends to include CCPC stock options in its new stock option regime. If you are concerned that CCPC stock options may get swept into a new regime, you may want to think about the following important considerations.

If CCPC employees wish to trigger the taxable benefit on their stock options before the top tax rate increases in 2016, they will need to exercise their options.

Exercise and sell shares

If CCPC employees wish to exercise their options and sell the shares, they should keep the following points in mind:

Pre-payment of tax - CCPC employees may effectively be pre-paying tax that could have been deferred by selling the shares in 2016 or later. The analysis to determine whether to pre-pay the tax should take into account the 2% federal tax savings that can be achieved in 2015 and should be done on a case-by-case basis.

Issues in selling private company shares - It may not be possible to immediately sell private company shares. Employees may be able to trigger the stock option benefit by disposing of the shares in other ways. However, such a disposition may not provide any cash to pay the tax on the stock option benefit.

Loss of future growth - By disposing of the shares, CCPC employees may forego future growth in the shares' value. In some cases, all or a portion of the growth may have been eligible for the capital gains exemption.

Exercise and hold shares

If CCPC employees wish to exercise their options and hold the shares, they should keep the following points in mind:

No pre-payment of tax - Because exercising CCPC stock options and holding the shares does not trigger the stock option benefit, employees will not have to pay tax on the benefit immediately.

Risk of capital loss – It's important to note that if the shares lose value after the options are exercised, the capital loss cannot be used to offset the taxable stock option benefit. On the other hand, employees of CCPCs may be able to claim an allowable business investment loss (ABIL) to help offset the taxable benefit inclusion. However, ABILs have limits. Further, often CCPCs go public, turning losses on shares acquired under subsection 7(1.1) options into ordinary capital losses, not ABILs.

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We can help

Your KPMG adviser can help you assess the effect of the upcoming stock option rules on your business and personal finances, and point out ways to take advantage of any benefits arising from the decision or help mitigate its impact. For more details, contact your KPMG adviser.

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