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Employee stock options

MAKING AN IMPACT THAT MATTERS since 1845

June 2, 2021 Webcast

Agenda and Introduction

Webcast 1	Content
June 2, 2021	- Overview of the current stock option regime and proposed stock option changes - $200k limit how it works and the impact - Corporate deduction: how it works and the impact - Strategic considerations on the future LTIP design and compensation mix

Our presenters

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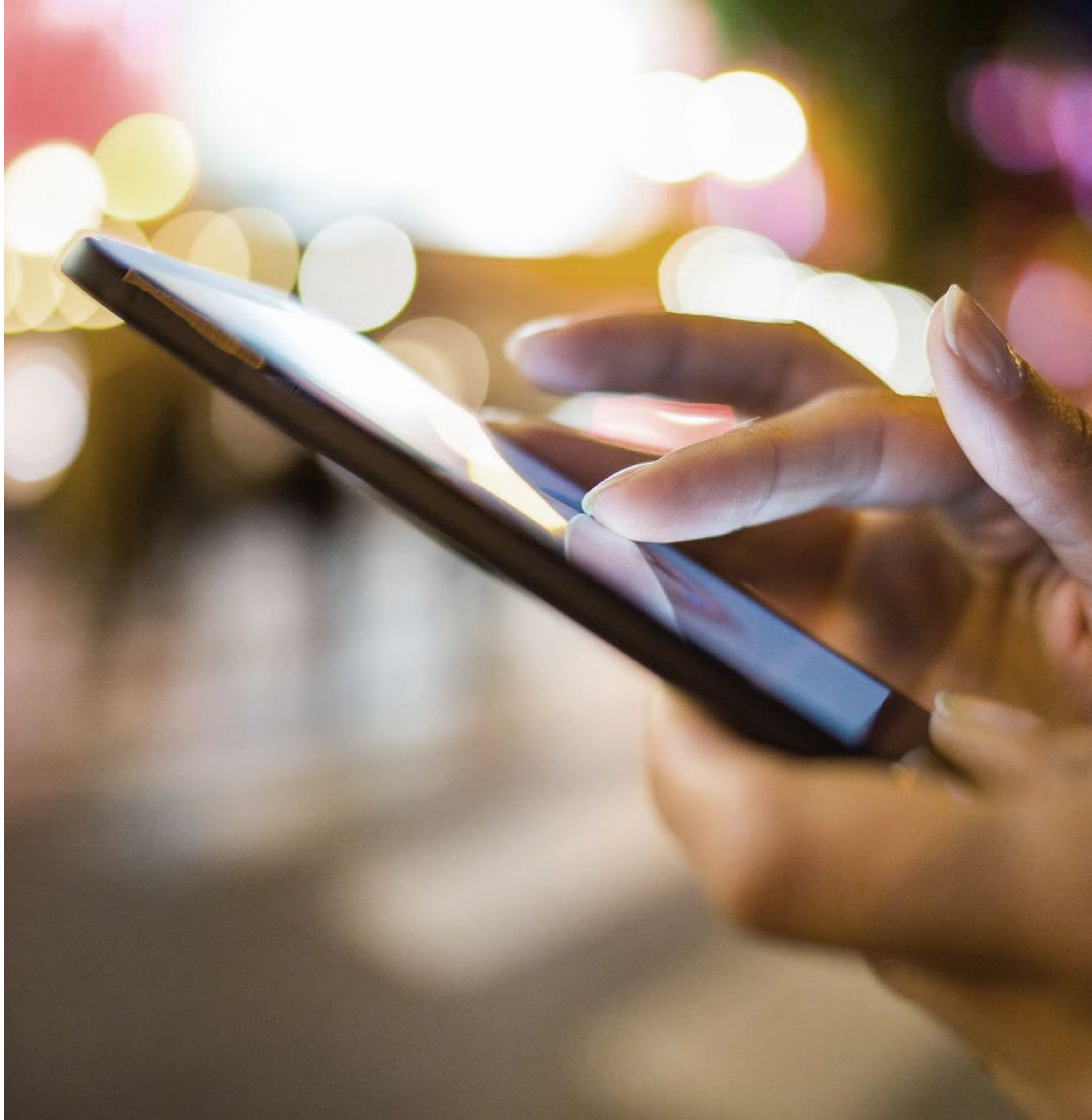
Polling question



Overview of the Current Stock Option Regime

Implications

The current usage of stock options in an employee's overall compensation package is highly dependent on the business structure

Business type	**Start-Up**	**PE Owned**	**Mature Private**	**Public**
Option grant usage	High	High	Medium	Medium
Potential impact of new rules	Low	Medium	Medium	High
Population	Broader group of employees	Top executives	Select group (Management and above)	Select group
Key differentiators	Time vesting conditions Significant component of an employee's compensation package	Vesting and/or exercisability tied to Exit Event (e.g., corporate transaction, IPO)	Not standardized approach (dependent on the business)	Used as part of broader long-term equity compensation package Annual grants
RSU/PSU grant usage	Low	Low	Medium	High

Overview of the Proposed Stock Option Changes

Key Aspects of Changes in Stock Option Taxation

What?

Annual limit of $200,000 will apply

Who?

Non-CCPC with annual gross revenues greater than $500M

Why?

"Fairer and more equitable" system

When?

July 1, 2021

Overview of the Current Stock Option Regime

Current non-CCPC Stock Option Taxation: Example

Time of Grant

Options Granted: 30,000

Exercise Price: $20

Time of Exercise

Stock Price: $30 − Exercise Price: $20 = Gain per Option: $10

× Options Granted: 30,000

Pre-Tax Option Gain: $300,000

Taxation

Pre-Tax Option Gain: $300,000 × Half of [50%] Marginal Tax rate: 25% = Taxes Payable: $75,000

After-Tax Value: $225,000

* Employees resident of Quebec may be either taxed at a marginal rate of 25% or 33% on the Option Gain

Overview of the Proposed Stock Option Changes

New Stock Option Taxation: Example

Time of Grant

Exercise Price: $20

Options Granted: 30,000

Qualified Options: 10,000

Non-Qualified Options: 20,000

Time of Exercise

Share Price: $30

Qualified Options Gain: $100,000

Non-Qualified Options Gain: $200,000

Taxation

Half of [50%] Marginal Tax Rate: 25%

Taxes Payable: $25,000

After-Tax Value: $75,000

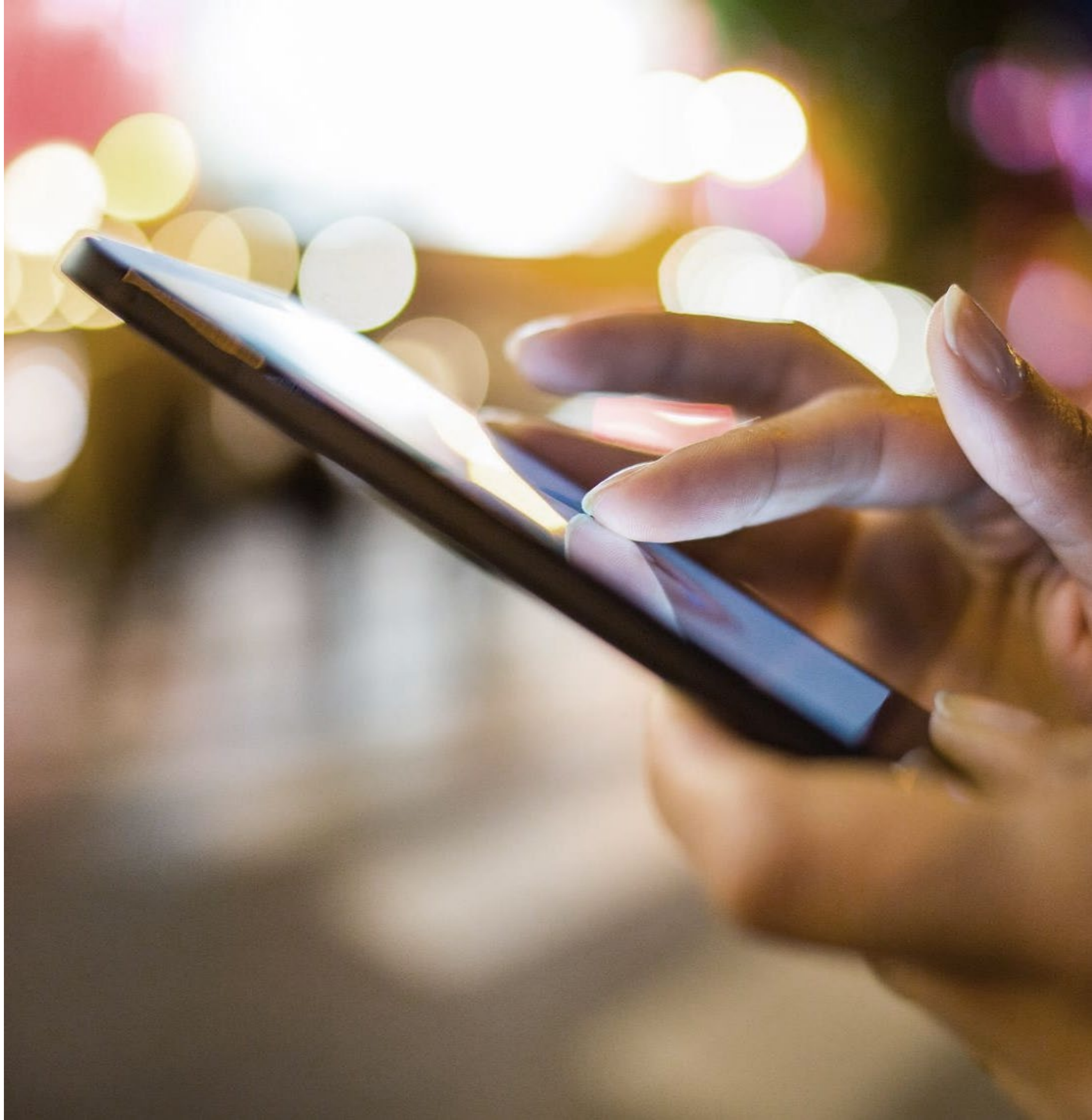
Marginal Tax Rate: 50%

Taxes Payable: $100,000

After-Tax Value: $100,000

Total After-Tax Value: $175,000

Polling question



$200k Limit: How it Works and the Impact

Mechanics of $200,000 Annual Limit

The **$200,000** annual limit on stock option deduction is linked to the vesting date of the stock options, but determined at time of grant

The employer must explicitly allocate options being linked to the **$200,000** limit (i.e., qualified options); employers will be able to choose whether to grant options that provide the employee the **$200,000** limit or not

$200k Limit: How it Works and the Impact

New Limit on Stock Option Deductibility

The $200,000 limit is based on the value of the shares underlying the options, not the grant date compensation value

*An employee receives an option award with a Grant Date Compensation Value of **$150,000***

Assumptions

- Exercise/Share Price at Time of Grant: $20
- Black-Scholes Value Per Option: $5

Definition	Number	Value
Grant Date Compensation Value	30,000 options ($150,000/$5)	$150,000
Value of Underlying Shares	30,000 shares	$600,000 (30,000 x $20)

Since the share price at the time of grant is $20, the preferential tax treatment will be limited to 10,000 “qualified” options (**underlying value of 10,000 x $20 = $200,000**).

The balance of “non-qualified” options will be subject to full marginal income tax rates

$200k Limit: How it Works and the Impact

Grant Size and Impact of New Option Taxation

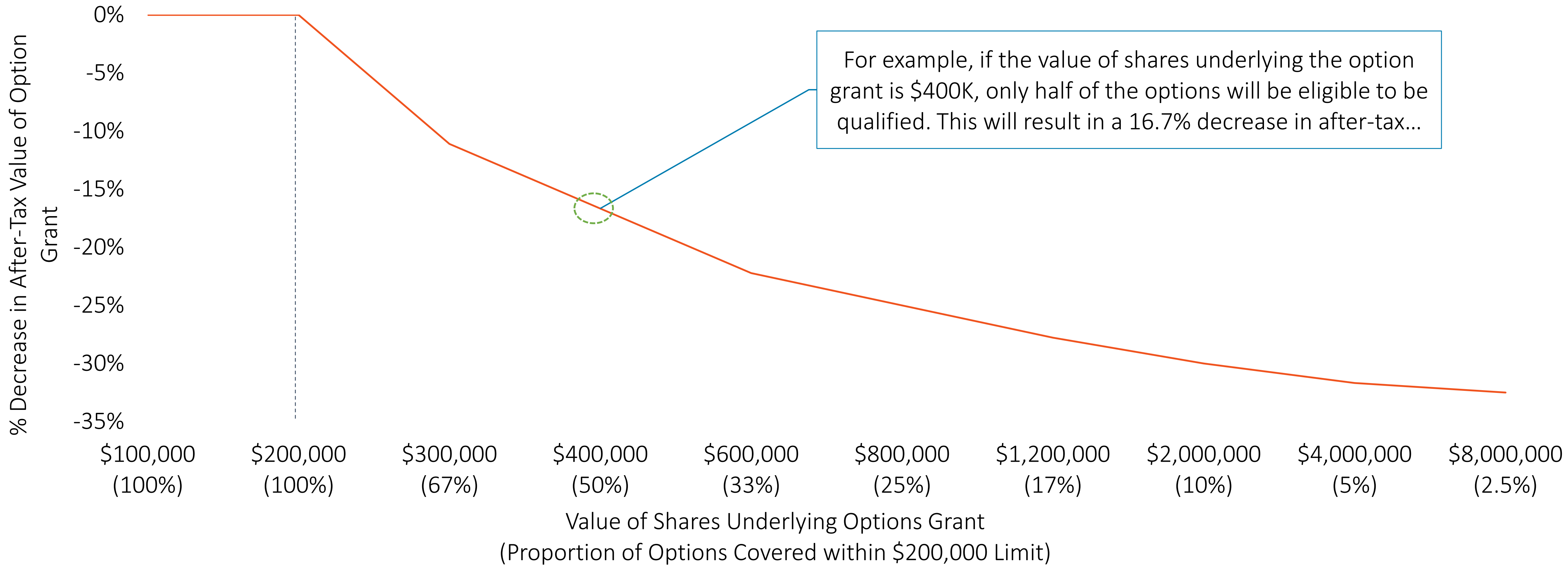
The increase in stock option taxation will vary depending on the size of the option award and the proportion of options within the $200,000 deduction limit. Larger grants of options will experience a greater proportional decrease in after-tax value.

Value of Shares Underlying Options Grant	**Proportion of Options Covered within $200,000 Limit**	**% Decrease in After-Tax Value of Option Grant**
$200,000	100%	0%
$400,000	50%	-16.7%
$800,000	25%	-25.0%
Grant only non-qualified stock options	0%	-33.3%

$200k Limit: How it Works and the Impact

Grant Size and Impact of New Option Taxation (cont.)

The increase in stock option taxation will vary depending on the size of the option award and the proportion of options within the $200,000 deduction limit. Larger grants of options will experience a greater proportional decrease in after-tax value.

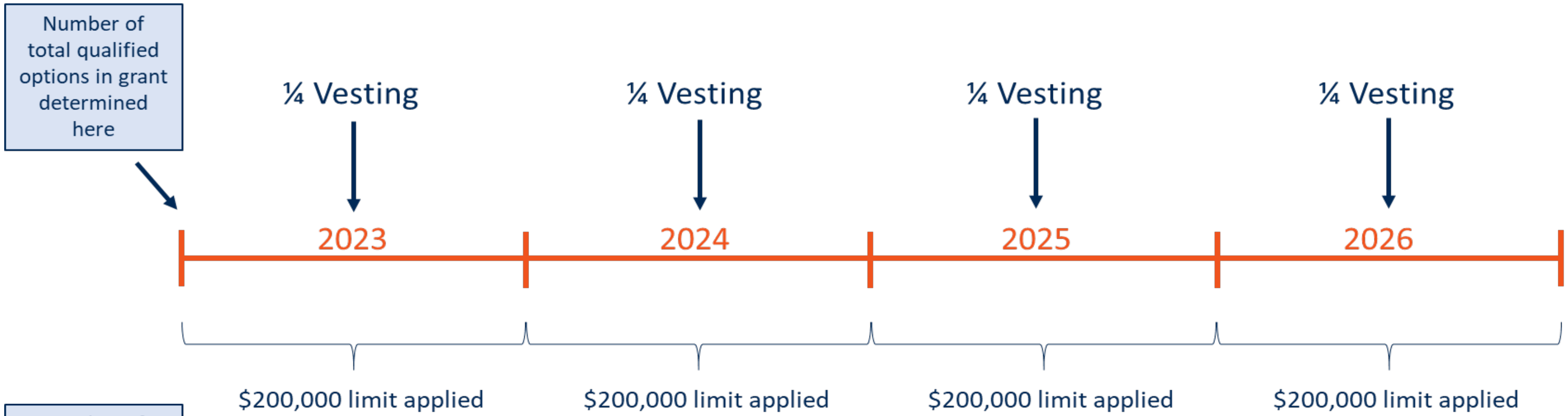


$200k Limit: How it Works and the Impact

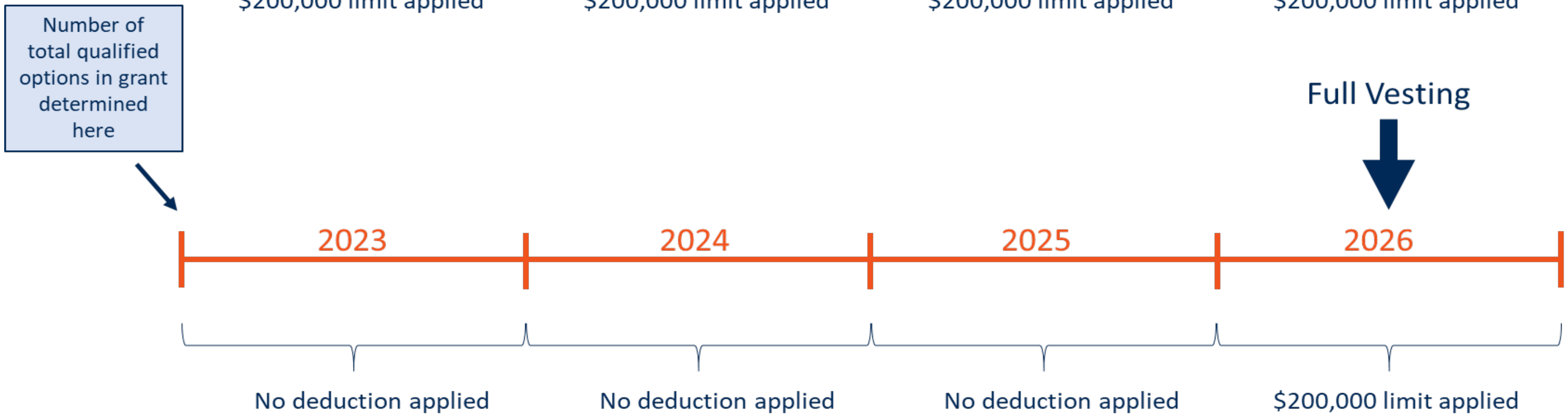
Stock Option Vesting

Vesting structure has implications on the number of options that can be qualified.

Ratable Vesting



Cliff Vesting



Corporate Deduction: How it Works and the Impact

Employer Deduction and Ability to Qualify or Not Qualify Options

1. In situations where the employee is paying tax at regular rates on a stock option gain, the company will receive a commensurate corporate income tax deduction

2. Employers have the ability not to offer the $200,000 tax deductible limit on option grants (i.e., “non-qualified” options)

> *“Employers subject to the new rules would be able to choose whether to grant employee stock options under the existing tax treatment, up to the $200,000 limit per employee, or whether to grant employee stock options under the new tax treatment (i.e., ineligible for the employee stock option deduction, and instead eligible for a deduction for corporate income tax purposes).”*

Corporate Deduction: How it Works and the Impact

Corporate Tax Deductible Expense on Non-Qualified Options

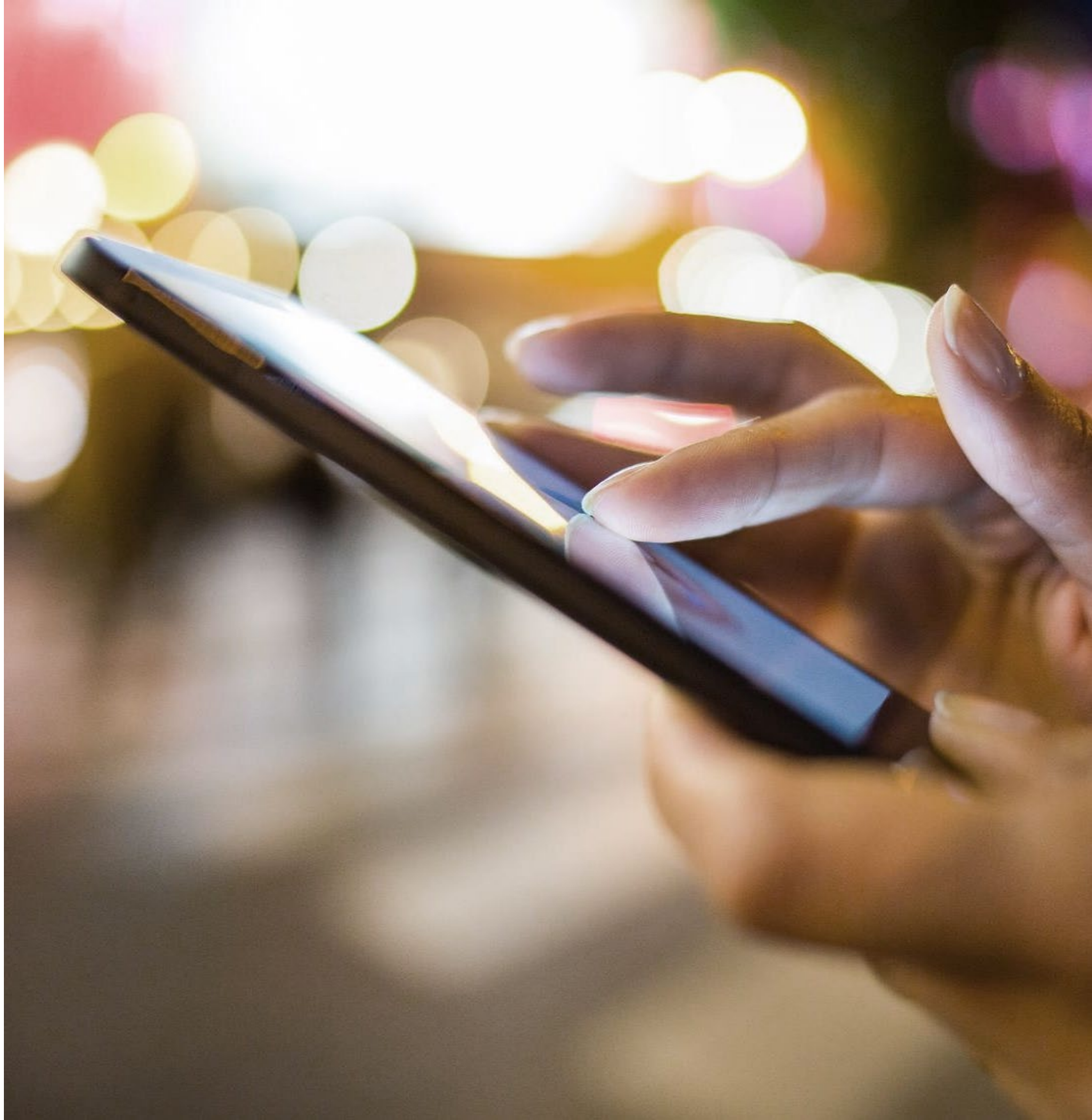
Employers will receive a tax-deductible expense equal to the option benefit realized by employees when exercised

Accounting Cost of Options ($000)
$1,000

	Tax Deductible Expense = Stock Option Benefit			
Annual Share Price Growth for 7 Years	3%	6%	9%	12%
Stock Option Payout (In-the-Money) Value ($000)	$919	$2,015	$3,312	$4,843
Payout as Multiple of Accounting Value	0.9x	2.0x	3.3x	4.8x

Grant Date Details
200,000 units
$20 Share Price
25% Black-Scholes Ratio

Polling question



Strategic Considerations on the future LTIP Design and Compensation Mix

Review of Current LTIP Mix

For some issuers, the change in stock option taxation will be a good time to review the LTIP mix

Consider the optimal place of stock options within the LTIP mix going forward

Main-stream alternatives to stock options (RSU/PSU)

Consider other long-term incentive alternatives

Strategic Considerations on the Future LTIP Design and Compensation Mix

Key Takeaways

Many decisions to be made…

- Qualified vs non-qualified stock options
- Corporate deduction

  Administrative complexity
- Shareholder vs employee perspective
- Where to go next?

  Self-reflection exercise

Q&A

Webcast 2 Reminder!

Webcast 2	Content
June 9, 2021	- Tax technical comments related to corporate deductibility on non-qualified securities - Increased reporting requirements - Optimization strategies related to stock options granted in the new legislative environment, including potential compensation alternatives in the context of the new environment

Thank you!

For additional questions, please contact cagestax@deloitte.ca

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