PROPOSED CHANGES TO STOCK OPTION TAXATION

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The long-anticipated changes to Canadian stock option taxation are set to be effective July 1, 2021. The federal government, in the draft legislation released on November 30, 2020, provided details regarding the new limit on the eligibility of employee stock options to receive preferential "capital gains-like" treatment. For many companies, the impending changes mark an opportune time to review the LTIP design. This briefing is focused on the new stock option taxation rules; a follow-up briefing will cover revamping the LTIP strategy and design.

Highlights of the Changes in Option Taxation

New Annual Limit on Stock Option Deductibility	▪ An annual limit of $200,000 will apply to employee stock options that can qualify for the stock option deduction (i.e., "qualified options"); this limit will be based on the market value of shares underlying the options at the time of grant ▪ All other options (i.e., "non-qualified options") will be taxed at marginal income tax rates, similar to RSUs and PSUs ▪ There will be a complicated process for the employer to allocate the $200,000 deduction limit, which is linked to the vesting date of the options, but determined at the time of grant ▪ Employers will have the ability to forgo the allocation and grant only non-qualified stock options

Affected Companies and Employees	▪ Non-CCPC (Canadian Controlled Private Corporations) with consolidated annual gross revenues greater than $500 million will be subject to these changes
	  o This includes Canadian subsidiaries of foreign parent corporations that meet the revenue threshold
	  o Companies not subject to these new rules will not be permitted to opt in
	▪ Employees who are Canadian taxpayers

Employer Tax Deduction	▪ At the time of exercise of non-qualified options, the employer will receive a tax-deductible expense equal to the option benefit (i.e., in-the-money value) ▪ Note: the corporate tax deduction is delinked from the accounting cost in that the former is based on the option benefit at exercise, while the latter is based on grant date cost (e.g., Black-Scholes value)
Effective Date	▪ The new tax rules will apply to employee stock options granted on or after July 1, 2021

$200,000 Deduction Limit and Vesting

The $200,000 deduction limit on qualified stock options will be calculated on the underlying share price at the date of grant – note, this is different from the compensation value disclosed in the Summary Compensation Table. For example:

Exhibit A: Calculation of Deduction Limit

*An employee receives an option award with a Grant Date Compensation Value of **$150,000**. The share price at the time of grant is $20, and the Black-Scholes value of each option is $5 (25% of the share price). This results in a grant of $150,000 / $5 = **30,000 options**.*

- *Of this, the portion of qualified options is **10,000 options**, which is the deduction limit of $200,000 divided by the share price of $20*
- *The balance of **20,000 options** is non-qualified and is subject to full marginal income tax rates*

While the calculation of the $200,000 deduction limit is relatively straightforward, the process of determining qualified options will be more complicated depending on the vesting structure. The allocation of the deduction limit will be linked to the vesting date of the stock options, but determined at the time of grant. For example:

Exhibit B: Ratable Vesting

*Using the same example above, if the options vest 25% on each of the first, second, third, and fourth anniversaries of the grant date, this would mean **7,500 options** vest each year.*

The value of shares underlying the options vesting each year would be $20 x 7,500 options = $150,000. This annual amount would be lower than the $200,000 deduction limit, which means if there are no other grants of options in preceding years, this entire grant of 30,000 options would be eligible to be qualified options.

Exhibit C: Cliff Vesting

If, however, the options vest 100% on the fourth anniversary of the grant date, the value of shares underlying the options vesting would be $20 x 30,000 options = $600,000. This amount would exceed the $200,000 deduction limit, which means only 10,000 options ($200,000 / $20) would be eligible to be qualified options.

Companies that provide annual grants of stock options may find additional complexities in allocating the $200,000 deduction limit across different tranches of options. The allocation may be based on the calendar year the options first become exercisable, using effectively a First In, First Out (FIFO) approach – i.e., if more than one tranche of options vest at the same time, the tranche granted first would have the $200,000 annual limit applied before

subsequent grants. In the end, the employer will need to determine what options to qualify (if any) up to the $200,000 deduction limit – and this must be done at the time of grant.

Key Issues and Questions

For many companies, the anticipated changes to option taxation will give rise to a number of tactical issues relating to the usage of the $200,000 deduction limit and strategic considerations on the role of stock options in incentive design going forward. In the short-term, companies will need to determine whether to qualify stock option grants, and the extent to which they will "optimize" the allocation of the $200,000 deduction limit.

We caution against having tax optimization override the principles underpinning prudent incentive design. However, companies may be able to take a number of approaches to facilitate the qualifying of stock options without compromising key principles, including avoiding early exercise.

- Since most companies do not vest options until at least a year after grant, the $200,000 deduction limit for 2021 and 2022 will effectively be lost; for companies with cliff vesting of options, there will be additional years lost – Should the company consider if and how to qualify options and/or adjust vesting in a manner that accommodates individual tax situations?
- While non-qualified options are fully taxable to the recipient, the company will receive a tax-deductible expense equal to the option gain on exercise – How may this impact a company's decision to qualify or not qualify stock options?
- For multi-national companies, how does the limit in Canadian stock option tax deductibility compare to other tax jurisdictions?
- How may societal factors impact the degree to which companies seek to minimize the increase in taxation for option recipients?

Companies will want to be mindful of knee-jerk reactions to maximize the usage of the $200K deduction limit as it relates to the next grant of options. The degree to which such an approach maximizes the benefit depends on the actual gain (in-the-money value) of the grant of options versus subsequent grants.

For many companies, now is a good time to review the LTIP design. Companies may wish to revisit the pay and performance philosophy and how the changes in option taxation may impact the role of options in their LTIP design going forward. Consider, for instance:

- What is the optimal place of stock options within the LTIP mix? On balance, do the advantages of stock options still hold notwithstanding the changes in taxation?

- What are the trade-offs between stock options and mainstream alternatives of RSUs and PSUs, and how will the new tax rules impact the risk-reward balance?
- Are there other long-term incentive alternatives that could be considered beyond the traditional 3-year RSU and PSU structures?

Conclusion

The upcoming changes to stock option taxation, though not yet enacted into law, are not expected to change substantially from the November 2020 draft legislation. While at a surface level the changes will harmonize the taxation of stock options with RSUs and PSUs, the $200,000 deduction limit provides a unique complexity for companies in their decision to qualify or not qualify option grants. In making their decision, it will be important for companies to consider the interests of shareholders, other stakeholders, and option recipients.

For further information, or for support with addressing the unique circumstances of your organization, we invite you to reach out to a Hugessen consultant.

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