Keeping the Options Open

Readers of the business news are often treated to headlines that CEOs receive compensation in the multi-millions of dollars. A large portion of this may be cash but, generally when the compensation goes from the absurd to the ludicrous, stock options are involved. Stock options are often given by start-up business to incentivize employees to work in a cash poor business in the hope that it will ‘hit it big’. The drafters of the Income Tax Act understood this and the Act contains provisions designed to encourage the use of stock options to compensate employees. So, it was with dismay, that the Government observed the use of these tax provisions by CEOs of major, established, corporations to receive astonishing, after-tax, compensation.

Budget 2019 effectively declared war on this practice. At the time, the Government did not publicize the measures they would take to attack what they thought was a misuse of the Act, but on June 17th the Government offered a peek at their proposed regulations.

In addition to the incentive to use stock options in the first place, there was an additional incentive program to encourage those who seek such options to donate the shares to charity. Under the (now old) rules, an individual who exercised a stock option was, depending on the nature of the corporation which granted the option, entitled to a deduction of 50% of the taxable benefit. This reduction was increased to 100% where the individual exercised the stock option and then donated the shares (or within 30 days of a sale – the cash proceeds from the sale of the shares) to a registered charity. For the purposes of our discussion, it is not necessary to define the taxable benefit, but for those who are interested, it is effectively the difference between the strike price and the fair market value on the date that the option is exercised, less any amount that is paid for the option itself.

The background released by the department of finance on June 17th indicated the following:

> *Under the current tax rules, if an employee donates a publicly listed share (or the cash proceeds from the sale of a publicly listed share) acquired under an employee stock option agreement within 30 days of the exercise of the option to a qualified donee, such as a registered charity, the employee is eligible for an additional deduction equal to one-half of the employee stock option benefit. As a result, where both the stock option deduction and the additional deduction in respect of a qualifying donation are available, the entire employee stock option benefit is effectively excluded from income. Donations of shares of private corporations are not eligible for the additional deduction.*
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> *If an employee donates a publicly listed share acquired under a stock option that is subject to the new tax rules, the employee will not be eligible for a tax exemption on any associated employee stock option benefit. Any capital gain that has accrued since the share was acquired under the stock option agreement will continue to be eligible for the full exemption from capital gains tax, subject to existing rules.*

This statement needs to be read carefully. The actual technical documents do not delete paragraph 110(1) (d.01) from the Act. Indeed, the technical documents state that the new definitions apply to the Act, in fact, apply to this paragraph as well. So, it would seem that the incentive to donate still exists.

What seems to have changed, is that the stock option system is now being divided into 2 different plans. Indeed, this would seem to be consistent with the Government's announcements in Budget 2019, which wants to keep the incentive program for those corporations that need it for growth, but limit the tax benefits by large established corporations. The June announcements indicate that the Government is still seeking consultation on the nature of how best to delineate the difference between the stock options of the various corporations, but it would seem that, at least for those smaller corporations which grant stock options, the additional deduction extant on the donation of those shares is not in danger of being removed.

While it is easy to understand the Government's interests in this matter, one would have hoped they would have found a way to keep the extra incentive for the donation of all shares gained by options. Indeed, the value of donating shares of large publically traded companies will clearly outweigh the benefit of donating corporations of less value, so it would be in the charity sector's best interests to consider approaching the government on this issue.

We will continue to follow these developments to see whether the new mechanisms put in place by the department of finance have any significant impact on the relevant donation incentives.