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Marmer Penner Inc. Newsletter

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Preparing for Changes in Stock Option Taxation

Many readers and their clients are bracing themselves for the impact of the new Liberal tax promise to raise the highest marginal income tax rate by 4% in 2016. However, another election promise was to limit the benefits of the employee stock option deduction, perhaps by placing a cap on the amount that may be claimed.

Under current income tax legislation, in general, when an employee stock option is exercised, the difference between the share value and the exercise price is added to the employee's income. For most options, a deduction equal to 50% of this benefit is permitted in order to effectively reduce the tax to that of a capital gain.

In general, it is to the investor's advantage to wait as long as possible to exercise a stock option so that growth can accrue before an employee has to risk any of his or her money. However, senior executives with a significant amount of accrued stock option benefits were most concerned about the Liberal promise (or threat, depending on one's viewpoint). Those who gave it thought weighed the advantages of exercising later to defer tax and payment against the disadvantages of a higher future tax rate and the possibility that the 50% employee stock option deduction might not even be available in the future.

In recent comments to the press, the new finance minister, Bill Morneau, has pledged not to apply retroactive tax changes, meaning that the new tax limitations on the employee stock option deduction will apply only to employee stock options granted after the date of the next economic update or federal budget.

These two expected income tax changes will have a significant drag on the value of employee stock options for matrimonial purposes and may spell the end of employee stock options as a form of remuneration for many companies. After all, employee stock options are non-deductible to the employer, so if they became fully taxable to the employees, there will be no economic incentive to use them. Paying a deferred cash bonus will be equally advantageous to the employee and much cheaper after-tax to the employer.

Of course, there will be no such changes to the taxation of employee stock options south of the 49th parallel. So, to executives used to the perks of lower taxed options, moving to the U.S. will become an attractive “option”. Will the increase in the tax rate on employee stock options from 23% in 2014 to 53% in 2016 initiate the next brain drain?