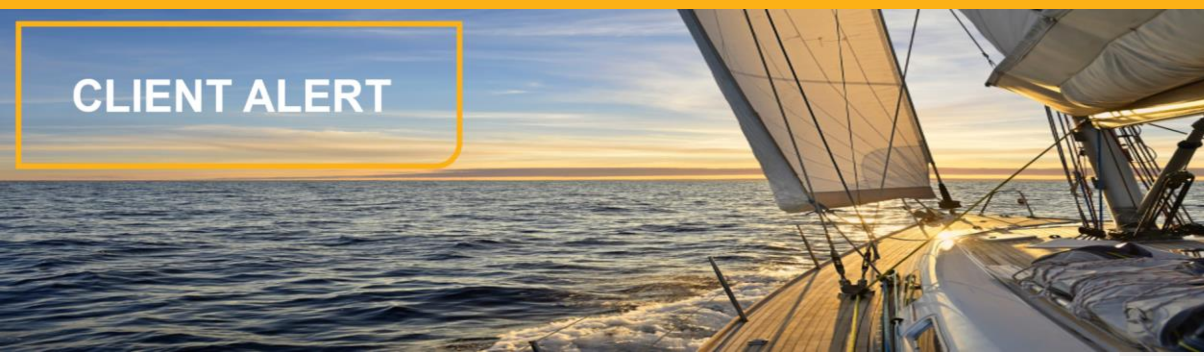


The Federal Budget and What it Means for Long-Term Incentives

The 2024 federal budget includes regulatory updates that change the effective tax rate on stock option exercises after June 24, 2024. These changes will not have a significant impact on the value of stock options for highly compensated employees, but they do change the value proposition for other employees. As a result *we expect options to continue to decline in prevalence.*

Background – the Tax Landscape for Stock Options

Prior to the 2021 legislative changes, stock option use was notably higher in Canada than in the U.S. Since then, option use has trended lower.

Prior to 2021, stock option exercises by Canadian taxpayers received a tax deduction, providing effective capital gains tax treatment on the gains from their exercise. Starting in July 2021, most stock option awards do not qualify for this treatment and have been taxed at ordinary income rates upon exercise.

However, companies may continue to grant $200,000 of annual value of qualified stock options that are eligible for effective capital gains treatment.

Canadian-controlled private corporations (CCPCs) and companies with less than $500 million in gross annual revenues are exempt from these 2021 rule changes.

(For a more detailed review of the 2021 tax law changes, see Meridian's 2020 client update here.)

The 2024 Federal Budget and Its Impact

The 2024 federal budget proposed increasing the capital gains inclusion rate from one-half to two-thirds, on capital gains in excess of $250,000 realized after June 24, 2024. A corresponding reduction was proposed in the deduction that an individual can claim upon the exercise of options (i.e., from one-half to one-third).

The change to the capital gains rate applies to options that are otherwise eligible for effective capital gains tax treatment:

1. Qualified options that meet the existing $200,000 grant value limit.
2. Options granted before July 1, 2021 (which are all "qualified").
3. Options granted by CCPCs or companies with annual revenue less than $500 million (which are also qualified).

The table that follows illustrates hypothetical awards to two employees, with the impact of the 2024 tax law changes illustrated:

Commented [RL1]: Confirming this is accurate? I didn't see this called out in the budget and dont think the ITA amendment is out yet. I researched what other law firms/acct firms/hugessen published and only PWC and EY called out CCPCs - to say that the applicability remains unclear.

Canada's proposed changes to capital gains inclusion rate and stock option deduction has implications for employers/employees (ey.com)

Tax Insights: Will stock options continue to be an effective form of employee compensation? | PwC Canada

Commented [CM2R1]: The point here is not related to the new rules, but to the rules that were effective July 1, 2021. If your option granted in 2022 was from a company with revenue of less than $500M, it WAS eligible for cap gains rates. Hopefully that clarifies

Commented [RL3R1]: Thanks Chris, I agree with the rule in principle.
I understood the language above in red to cover the 2021 rules and this sentence to cover the applicability of the 2024 rules. But if I am misreading it then we are all good on this point.

- Both of these employees are Ontario taxpayers and pay taxes at the top marginal rate of 53.53%. We have assumed that both employees exercise options that were granted at the same time and as soon as possible after vesting (other tax deferral strategies are not considered in this example).
- Employee #1 (management employee) has a very valuable qualified option that was granted before July 1, 2021, and is worth $1.5 million at exercise. Employee #1 also exercises $400,000 of non-qualified option value at the same time.
- Employee #2 (senior executive) has the same qualified option as Employee #1, but Employee #2 is more highly compensated and exercises $4.2 million of non-qualified options at the same time Employee #1 is exercising $400,000.
- For purposes of this example, assume that these are the only capital gains incurred by either Employee #1 or Employee #2 for the year.

	Employee #1		Employee #2	
Qualified	1,500,000	1,500,000	1,500,000	1,500,000
Non-Qualified	400,000	400,000	4,200,000	4,200,000
Total	**1,900,000**	**1,900,000**	**5,700,000**	**5,700,000**
Deduction	**Pre-2024 Budget**	**Post-2024 Budget**	**Pre-2024 Budget**	**Post-2024 Budget**
Up to $250k	(750,000)	(125,000)	(750,000)	(125,000)
Above $250k	N/A	(416,667)	N/A	(416,667)
Taxable Income	**1,150,000**	**1,358,333**	**4,950,000**	**5,158,333**
Tax Rate	53.53%	53.53%	53.53%	53.53%
Taxes Payable	615,595	727,116	2,649,735	2,761,256
After-Tax Benefit	1,284,405	1,172,884	3,050,265	2,938,744
Effective Tax Rate	32.40%	38.27%	46.49%	48.44%
Difference in Effective Tax Rate		5.87%		1.96%

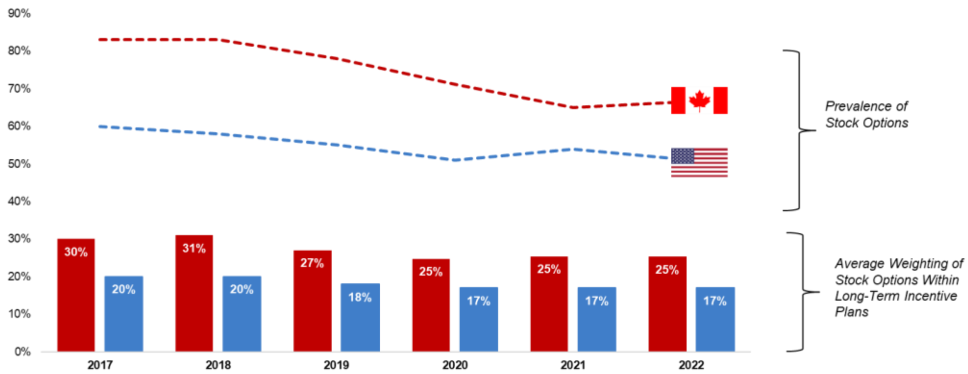
Because such a large fraction of Employee #2's option gains are non-qualified and taxes are paid at ordinary income rates, the impact to Employee #2's effective tax rate is not as significant as the impact to Employee #1's tax rate. Employee #2 always pays more in taxes, and at a higher rate. But the change in tax rate has a proportionally greater impact on Employee #1, because a greater proportion of Employee #1's options are qualified options.

The Potential Implications for Long-Term Incentive Program Design in Canada

Stock options are in decline as a long-term incentive vehicle in both Canada and the U.S. for several reasons:

- Rising capital markets may increase the value of options no matter how good (or bad) a company's performance has been. This is particularly true for companies – including many in the TSX Composite – whose share prices are highly correlated to energy or mineral prices that are set globally.
- Options are more dilutive than full-value share equity vehicles like restricted shares units (RSUs) and performance share units (PSUs).
- The increasing prevalence of treasury settled share unit plans provides an alternative vehicle that allows for a longer-term tax deferral and flexibility to monetize awards during employment.
- For public companies, some external observers do not view options as performance-based.

For many years, we have observed the phenomenon that option usage at Canadian companies is higher than at American companies. We think the difference in Canadian tax treatment, until 2021, was a main driver for this difference:



Note: Data presented for Canada reflects the S&P/TSX 60; U.S. data reflects the Meridian's Governance and Design Survey

Impact of the Tax Law Changes - Near Term

In the near term (before June 25, 2024), we think individuals with vested in-the-money stock options, eligible for effective capital gains treatment based on one of the 3 criteria above, will want to exercise those options before the tax rates change.

We do not expect companies to grant additional compensation (equity-based or otherwise) to offset the impact of higher tax rates in 2024; decisions about how much compensation to award are generally made without considering individual tax circumstances.

Impact of the Tax Law Changes - Longer Term

In the longer term, the combination of the 2021 and now the 2024 tax law changes make stock options a less attractive vehicle for compensating employees who are Canadian taxpayers, and more companies may conclude that the remaining tax benefits do not make up for the new drawbacks. We think the use of stock options is likely to decline. We expect options to be replaced by:

- An increase in performance-vested equity vehicles that incorporate leverage – i.e., PSUs that are at-risk with upside (and downside) payout opportunities.
- An increase in treasury settled share units (PSUs and RSUs). A merit of stock options is that they have a long deferral period before they must be exercised – typically seven to ten years. Cash/market purchase share units must be redeemed within approximately three years of grant, but treasury share units can have the same duration as a stock option, providing an attractive tax-deferred alternative. While still a minority practice, close to 1/5th of the S&P/TSX 60 companies now have treasury-settled share unit plans. Meridian regularly advises companies on the implementation of these plans.

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