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Tax Alert – Canada

Proposed changes to the capital gains inclusion rate and stock option deduction - what do they mean for employers and employees?

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 16 April 2024, as part of the 2024 federal budget (Budget 2024), the federal government proposed an increase to the capital gains inclusion rate for individuals on capital gains that exceed an annual limit. To reflect the new capital gains inclusion rate, the federal government also proposed a reduction in the employee stock option deduction for stock option benefits that exceed the annual limit. These changes effectively result in stock options and capital gains that exceed the annual limit being taxed at a higher effective rate as compared to under the current rules. For example, the top effective marginal tax rate for stock option benefits and capital gains that exceed the annual limit in Ontario will increase from 26.8% to 35.7%.

In this Tax Alert, we provide an overview of these changes and review certain implications for employers and employees. While employers will have time to implement the required changes to their processes and policies to comply with these proposals, employees now have a short time to assess their potential tax exposure before the new proposals take effect on 25 June 2024.

The proposals summarized below are outlined in the *Tax Measures: Supplementary Information* document, which accompanies the Budget 2024 package. The draft legislative details required to implement the proposed changes were not provided by the Department of Finance (Finance) in the Notice of Ways and Means Motion in Budget 2024 or in Bill C-69, *Budget Implementation Act, 2024, No. 1*, which received first reading in the House of Commons on 2 May 2024.¹ Finance notes in the Budget 2024 package that additional design details will be released in the coming months. More recently, Deputy Prime Minister and Finance Minister Chrystia Freeland stated that the enabling legislation to implement these proposals will be tabled before the House of Commons rises for the summer break on 21 June 2024.

The full impact of the proposed changes will need to be re-examined once the legislative details are released.

Background

Under the current rules, one-half of capital gains realized by Canadian taxpayers are included in their income. Budget 2024 proposes to increase the capital gains inclusion rate, for capital gains realized on or after 25 June 2024, from one-half to two-thirds for corporations and trusts, and from one-half to two-thirds on the portion of capital gains realized in the year that exceed \$250,000 for individuals.²

Currently, although the full amount of a stock option benefit is taxed as employment income, the employee may claim a deduction of one-half the stock option benefit, provided certain conditions are met.³ This results in stock options that meet the necessary conditions effectively being taxed at the same rate as capital gains.

Budget 2024 proposes to reduce the employee stock option deduction to one-third of the stock option benefit realized on or after 25 June 2024, to reflect the new capital gains inclusion rate. However, eligible individuals will be able to claim a deduction of one-half the stock option benefit up to a combined annual limit of \$250,000 for both employee stock options and capital gains.

¹ For more information on the income tax measures included in Bill C-69, refer to [EY Tax Alert 2024 Issue No. 27](#).

² For more information on the proposed change in the capital gains inclusion rate, refer to [EY Tax Alert 2024 Issue No. 28](#).

³ The stock option benefit is equal to the amount by which the fair market value of the shares at the time of acquisition exceeds (i) the amount paid by the employee for the shares, and (ii) any amount paid by the employee to acquire the option. The benefit is included in employment income under section 7 of the *Income Tax Act* (the Act). Generally, if the exercise price is no less than the fair market value of the shares at the date the option is granted, and certain additional conditions are met, the employee can claim a deduction under paragraph 110(1)(d) of the Act. These rules are modified in the case of Canadian-controlled private corporation (CCPC) stock options.

The annual \$250,000 threshold for individuals will be fully available in 2024 (i.e., it will not be prorated) and will apply only in respect of net capital gains (and stock option benefits) realized on or after 25 June 2024.⁴

Quebec has announced that it will harmonize the proposed increase to the capital gains inclusion rate but is still reviewing the proposed changes to the stock option deduction.

Potential implications for employers

The proposed change to the employee stock option deduction has the potential to further complicate the administration of stock option plans for employers.

Currently, the employer is required to report the stock option benefit on the employee's Form T4, *Statement of Remuneration Paid*,⁵ along with the amount of the benefit that is eligible for the stock option deduction. The employer is also required to withhold and remit an amount in respect of the stock option benefit as if the amount of the benefit had been paid as a bonus.⁶ When determining the amount subject to income tax withholding, the employer may reduce the benefit by one-half where the criteria for the stock option deduction are met.

Additional notification, reporting and tracking requirements apply to certain employers in respect of stock options granted on or after 1 July 2021 that are subject to a \$200,000 annual vesting limit (i.e., employers that are not CCPCs and earn \$500 million or more in gross annual revenue).⁷

At this time, it is unclear whether employers will be expected to withhold income tax on the benefit realized on the exercise of a stock option based on a one-third stock option deduction or whether a one-half deduction can be applied in situations where the stock option benefit is less than \$250,000. It will be difficult for the employer to determine the employee's ultimate tax rate because the \$250,000 threshold takes into account both stock option benefits and capital gains. This problem is particularly pronounced for stock options exercised early in the year when it is not known what options the employee may exercise later in the year or whether any capital gains will be realized by the employee.

⁴ Although not explicitly stated in the Budget 2024 package, it is assumed that for 2024 the annual \$250,000 limit will apply in respect of the combined amount of net capital gains and stock option benefits realized on or after 25 June 2024.

⁵ Where applicable, the benefit must also be reported on the Quebec Relevé 1 (RL-1 Slip), *Employment and Other Income*.

⁶ There is no income tax withholding requirement where a stock option benefit is received by an arm's length employee with respect to the disposition of CCPC shares.

⁷ For more information on the \$200,000 annual vesting limit on employee stock options, refer to [EY Tax Alert 2021 Issue No. 26](#). No changes have been proposed to the annual vesting limit introduced in 2021.

Guidance will also be needed from the Canada Revenue Agency on how employers are expected to report the stock option deduction on the employee's Form T4 to reflect the one-half or one-third stock option deduction. For example, there may be a need to distinguish between stock options exercised before 25 June 2024 and after 24 June 2024 on the employee's 2024 Form T4.

Potential implications for employees

Timing of exercise

Employees who hold vested stock options may want to consider whether to exercise their options prior to 25 June 2024 so that they can benefit from the one-half stock option deduction. Among other factors, this decision will depend on whether the employee expects to exceed the \$250,000 combined annual limit between the amount of the stock option benefit and capital gains in the year of exercise and the anticipated increase in share price over the years to come.

Generally speaking, the downside of exercising stock options before 25 June 2024 is that the employee will be giving up the options. Therefore, prior to exercising any stock options, employees may wish to consider the expected future increase in share price and the time to expiry on the options.

CCPC stock options

It is unclear how the proposed change to the employee stock option deduction will impact CCPC stock options, which have traditionally received more favourable income tax treatment than stock options issued by non-CCPCs. In the case of CCPC stock options, although the stock option benefit is crystallized at the time the employee exercises the option, the benefit is not subject to income tax until the year the employee disposes of the shares. Where the exercise price of the CCPC stock option is less than the fair market value of the share on the date of grant, the one-half deduction is generally only available if the employee holds the shares for at least two years before disposing of or exchanging them.⁸

It remains to be seen whether employees who exercised CCPC stock options before 25 June 2024 will be able to claim a deduction of one-half the stock option benefit if they dispose of the shares after 25 June 2024, or if they will be limited to the one-third deduction (after the \$250,000 annual limit is reached). Given that Budget 2024 did not distinguish between CCPC and non-CCPC stock options, it is possible that employees in this situation could be limited to the one-third deduction after the annual limit is reached.

⁸ Paragraph 110(1)(d.1) of the Act.

On 1 May 2024, the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada (the Joint Committee) made a submission to Finance that the legislation be structured to avoid this result. In the submission, the Joint Committee commented that the legislation should include a continuation of the one-half deduction for CCPC options exercised prior to 25 June 2024, irrespective of the year in which the employee disposes of the acquired shares.

Before considering a disposition or exchange of CCPC shares, employees who exercised CCPC stock options before 25 June 2024 should be mindful of the potential two-year holding period requirement for the stock option deduction.

Internationally mobile and nonresident employees

The proposed increase in the capital gains inclusion rate may result in an increase in departure tax for employees ceasing Canadian tax residency. Departure tax is the tax Canada imposes on departing residents on accrued but unrealized gains on certain assets, such as marketable securities, held when ceasing Canada residency.⁹

Employees who anticipate ceasing to be resident in Canada in the near future and having capital gains from the deemed disposition of property exceeding \$250,000 may wish to accelerate their departure date to before 25 June 2024 so that they can benefit from the lower inclusion rate. Alternatively, employees in this situation should consider planning opportunities that may be available prior to 25 June 2024 to crystallize existing accrued capital gains prior to incurring departure tax. The proposed alternative minimum tax changes expected to be effective from 1 January 2024 (which have yet to be enacted) also need to be considered on any capital gain crystallizations by individuals.¹⁰

The potential increase in departure tax for employees may also present a challenge for employers looking to attract talent from outside of Canada for assignments that may exceed a few years. Employees who are resident in Canada for more than 60 months are subject to departure tax on property they owned before becoming resident in Canada and on property they acquired while resident in Canada by bequest or inheritance.¹¹

For nonresident employees providing services both inside and outside of Canada, it is currently unclear whether the \$250,000 annual limit for the one-half deduction will apply to the employee's entire stock option benefit or only to the Canadian-sourced portion.

⁹ Several exclusions are available, including for employee stock options, pension rights and certain property owned by short-term residents of Canada.

¹⁰ Refer to [EY Tax Alert 2023 Issue No. 45](#) and [EY Tax Alert 2024 Issue No. 25](#) for a more comprehensive discussion of the proposed revisions to the alternative minimum tax.

¹¹ Subparagraph 128.1(4)(b)(iv) of the Act.

Conclusion

The proposals to increase the capital gains inclusion rate and reduce the employee stock option deduction give rise to some novel issues for employers and employees. However, since draft legislative proposals have not yet been tabled, limited information is currently available to fully assess the employer and employee implications of these proposals.

As these changes are expected to impact dispositions and stock option exercises that occur on or after 25 June 2024, employees expecting to be impacted have a limited amount of time to undertake any planning opportunities that may be available to reduce their income tax liability.

Consult your EY advisor to assess what these changes may mean for you and your employees. In addition to ensuring you continue to meet your compliance obligations, this may also be a good opportunity to revisit your total rewards strategy to determine if it still aligns with your business and talent objectives.

Learn more

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