Preface

These explanatory notes describe proposed amendments to the *Income Tax Act*. These explanatory notes describe the proposed amendments, clause by clause, for the assistance of Members of Parliament, taxpayers and their professional advisors.

The Honourable William Francis Morneau, P.C., M.P.
Minister of Finance

These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

Department of Finance Canada Ministère des Finances Canada

Clause 1

Special provision

ITA
7(7)

Subsection 7(7) of the *Income Tax Act* (the “Act”) defines “qualifying person” and “security” for the purposes of section 7 and certain other provisions of the Act relating to agreements under which employees of a corporation or a mutual fund trust acquire rights to acquire securities of the employer (or a person with whom the employer does not deal at arm’s length).

Subsection 7(7) is amended to have these definitions apply for the purposes of new subsection 110(0.1), new paragraph 110(1)(e) and new subsections 110(1.3), (1.31), (1.4), (1.41) and (1.9).

For more information, see the commentary on those provisions.

This amendment comes into force on January 1, 2020.

Clause 2

Definitions

ITA
110(0.1)

Section 110 of the Act provides various deductions that may be claimed in computing a taxpayer’s taxable income. New subsection 110(0.1) defines “specified person” and “vesting year” for the purposes of section 110. These terms are used in the context of non-qualified securities under stock option agreements. For further information, see the commentary on new paragraph 110(1)(e) and new subsections 110(1.3), (1.31), (1.4), (1.41) and (1.9).

“specified person”

The new definition “specified person” is relevant to the new rules relating to non-qualified securities and, in particular, the new deduction under paragraph 110(1)(e).

A specified person is defined as a qualifying person (defined as a corporation or mutual fund trust in subsection 7(7)) that is not:

- a Canadian-controlled private corporation; or
- a qualifying person that meets certain prescribed conditions.

“vesting year”

The new definition “vesting year” is relevant for the purposes of the $200,000 limit in new subsection 110(1.31), which deems certain securities to be non-qualified securities.
The term “vesting year” applies with respect to a security that a specified person has agreed to sell or issue to an individual under an agreement. It is generally the first calendar year in which

the individual may exercise the right to acquire the security. Where the agreement specifies the calendar year in which the individual's right to acquire the security first becomes exercisable, that calendar year will be the vesting year. Some agreements provide for an acceleration of the exercise right in the event of certain events that are not reasonably foreseeable at the time the agreement is entered into, such as the death of the individual. These accelerated vesting dates are not to be taken into consideration for the purpose of determining the agreement's vesting year.

Where the agreement does not specify the calendar year in which the individual's right to acquire the security first becomes exercisable, the vesting year will be the first calendar year in which the right to acquire the security can reasonably be expected to be exercised. For example, this may be the case where the right to acquire the security becomes exercisable as a consequence of the attainment of a metric based on sales, hours or performance.

The vesting year of a security to be acquired under an agreement to sell or issue securities to an individual is determined at the time the specified person agrees to sell or issue the security. As a consequence, the vesting year in respect of a security may differ from the year in which the security is acquired by the individual.

These amendments come into force on January 1, 2020.

Employee options

ITA
110(1)(d)

Paragraph 110(1)(d) of the Act provides a deduction in computing the taxable income of a taxpayer if certain conditions are met. The deduction is equal to ½ of the amount of the benefit deemed by subsection 7(1) to have been received by the taxpayer in respect of a security under an employee stock option agreement.

Paragraph 110(1)(d) is amended to not allow this deduction in respect of the amount of any benefit that is deemed to have been received by the taxpayer in respect of a non-qualified security.

New paragraph 110(1)(e) provides a deduction for the employer in respect of non-qualified securities. New subsections 110(1.3) to (1.4) contain the conditions under which a security is deemed to be a non-qualified security. For more information, see the commentary on those new provisions.

This amendment comes into force on January 1, 2020.

Employer deduction – non-qualified securities

ITA
110(1)(e)

New paragraph 110(1)(e) of the Act provides a deduction in computing the taxable income of a taxpayer if certain conditions are met. The deduction is equal to the amount of the benefit deemed by subsection 7(1) to have been received by an individual in respect of a non-qualified security under an employee stock option agreement.

In order for a taxpayer to claim the deduction under paragraph 110(1)(e) in respect of a stock option agreement with an individual, the taxpayer must be a specified person (as defined in subsection 110(0.1)) and must be the employer of the individual at the time the agreement is entered into. In addition, the notification requirements under subsection 110(1.9) must be met in respect of the security.

There is also a requirement that a deduction under paragraph 110(1)(d) would have been available if the security were not a non-qualified security. This requires that certain conditions under subsection 110(1)(d) must be met in respect of the option:

- the employee must be dealing at arm's length with the employer at the time the option is granted;
- the exercise price of the option must not be less than the fair market value of the security at the time the option is granted (*i.e.*, it must not be 'in the money'); and
- the security must be a prescribed share (under section 6204 of the *Income Tax Regulations*).

Securities to be sold or issued under a stock option agreement can be non-qualified securities where the agreement provides that a specified person that does not deal at arm's length with the employer will sell or issue its securities to the employee. In such a circumstance, paragraph 110(1)(e) provides the deduction to the employer and not the issuer of the securities.

For more information, see the commentary on new subsections 110(1.3), (1.31), (1.4), (1.41) and (1.9).

This amendment applies in respect of agreements to sell or issue securities entered into after 2019.

Determination of non-qualified securities

ITA
110(1.3)

New subsection 110(1.3) of the Act provides the conditions that must be met for subsection (1.31) to apply. Subsection (1.31) deems securities to be non-qualified securities if they are to be issued under an employee stock option agreement with a specified person and an annual $200,000 vesting limit is exceeded. Whether a security is a non-qualified security is relevant primarily for the purposes of the deductions in paragraph 110(1)(d) and new paragraph 110(1)(e).

Specifically, subsection (1.3) provides that subsection (1.31) applies if a particular specified person agrees to sell or issue its securities (or securities of another specified person that does not deal at arm's length with the particular specified person) to one of its employees (or an employee of another specified person that does not deal at arm's length with it).

This amendment applies in respect of agreements to sell or issue securities entered into after 2019.

Annual vesting limit

ITA
110(1.31)

New subsection 110(1.31) of the Act applies to securities to be sold or issued by a specified person under a stock option agreement if the conditions in new subsection 110(1.3) are met in respect of that agreement.

This subsection provides a formula for calculating the proportion of securities under a stock option agreement that are deemed to be non-qualified securities. The deduction for employees under paragraph 110(1)(d) is not available in respect of non-qualified securities while the deduction for employers under paragraph 110(1)(e) is available only in respect of non-qualified securities.

The $200,000 limit provided by the formula applies in respect of each vesting year. And so, if a portion of the securities to be sold or issued under an agreement have a particular vesting year and others have another vesting year, the formula is applied separately in respect of each of those years.

The proportion of securities to be sold or issued under an agreement that is deemed to be non-qualified securities is expressed by the formula A/B. Variable B is the total fair market value (determined at the time the agreement is entered into) of the securities to be sold or issued under the agreement for the particular vesting year that is being tested. The description of A contains another formula, which incorporates the $200,000 limit. If the amount to be determined for the formula "C + D - $200,000" would otherwise be negative, section 257 deems that amount to be nil, which results in none of the securities being deemed to be non-qualified securities.

As with variable B, the description of C is based on the total fair market value (at the time the agreement is entered into) of securities to be sold or issued under the agreement for a particular vesting year. Variable D is the lesser of $200,000 and the total fair market value of securities to be sold or issued in respect of other agreements (whether entered into previously or contemporaneously) for that vesting year. This variable therefore brings into consideration the relevant amounts for securities to be sold or issued under other agreements that have the same vesting year. It also provides an ordering mechanism where agreements are entered into at different times in respect of securities that have the same vesting year (*i.e.*, the subsection is applied first to the earliest agreement).

Example:

Mckayla is an employee of Xco, which is a specified person. In 2020, Xco agrees to grant her 70,000 employee stock options to acquire 70,000 shares of Xco, each with a strike price of $2 (the fair market value of the underlying securities at the time the options are granted). The first year Mckayla will be able to acquire those securities is in the 2022 calendar year.

The proportion of those securities that is deemed to be non-qualified securities is:

A/B
A = C + D - $200,000
where

C = $140,000 (i.e., 70,000 x $2)
D = is the lesser of

(i) $200,000; and

(ii) 0
A = 0 (i.e., $140,000 + 0 - $200,000)
B = $140,000
A/B = $0/$140,000

As a result, none of the securities are non-qualified securities.

In 2021, Xco agrees to grant Mckayla 50,000 employee stock options to acquire 50,000 shares of Xco with a strike price of $2 (the fair market value of the underlying securities at the time the options are granted) with a vesting year of 2022.

The proportion of those securities that is deemed to be non-qualified securities is:

A/B
A = C + D - $200,000
where

C = $100,000 (i.e., 50,000 x $2)
D = is the lesser of

(i) $200,000; and

(ii) $140,000 (i.e., the amount for C for the previous options with the same vesting year)
A = $40,000 (i.e., $100,000 + 140,000 - $200,000)
B = $100,000
A/B = $40,000/$100,000

As a result, 20,000 securities (i.e., 50,000 x $40,000/$100,000) are deemed to be non-qualified securities.

This amendment applies in respect of agreements to sell or issue securities entered into after 2019.

Non-qualified security designation

ITA
110(1.4)

New subsection 110(1.4) of the Act allows an employer that is subject to the $200,000 limit in subsection (1.31) to designate one or more securities under an employee stock option agreement to be non-qualified securities for the purposes of this section. As with the deeming rule in subsection (1.31), the securities may be securities of that employer or of another specified person with whom the employer does not deal at arm’s length.

For more information, see the commentary on new paragraph 110(1)(e) and new subsections 110(1.3), (1.31) and (1.9).

This amendment applies in respect of agreements to sell or issue securities entered into after 2019.

Ordering of acquisition of securities

ITA
110(1.41)

New subsection 110(1.41) of the Act provides an ordering rule for the purpose of determining whether a security acquired on the exercise of an employee stock option agreement is a non-qualified security.

This subsection is relevant where an employee exercises a right to acquire some, but not all, of the securities that the employee could acquire under one or more stock option agreements and the securities acquired could be either non-qualified securities or securities that are not non-qualified securities (in this note referred to as "qualified securities"). This may be the case where, for example, the employee has a number of identical options or one agreement that could result in the acquisition of qualified securities or non-qualified securities.

Under this subsection, the taxpayer is considered to acquire qualified securities first, before acquiring any non-qualified securities.

Example:

Andrew is an employee of a Yco, a specified person. In 2021, Yco grants Andrew options to acquire 300,000 shares with a strike price of $2 per share (the fair market value of the underlying securities at the time the options are granted) and a vesting year of 2022. Yco does not agree to sell Andrew any other securities with that vesting year.

Under subsection 110(1.31), 200,000 of those shares will be non-qualified securities and 100,000 of the shares will be qualified securities.

If Andrew chooses to exercise his right to acquire 150,000 of those 300,000 shares in 2022, he is considered to exercise options to acquire the 100,000 qualified securities first, with the remaining 50,000 shares being non-qualified securities.

This amendment applies in respect of agreements to sell or issue securities entered into after 2019.

Notification – non-qualified security

ITA
110(1.9)

New subsection 110(1.9) of the Act provides notification obligations in respect of agreements to sell or issue non-qualified securities.

If a security is deemed to be a non-qualified security under subsection (1.31), the employer must notify the employee in writing that the security is a non-qualified security on the day that the agreement is entered into. This condition is not necessary for securities that are deemed to be non-qualified securities under subsection (1.4) because the designation as non-qualified securities in accordance with that subsection is made under an agreement to which the employee is a party.

If a security is deemed to be a non-qualified security under either subsection (1.31) or (1.4), the employer must notify the Minister of Revenue in prescribed form that the security is a non-qualified security with its return of income under Part I of the Act for the taxation year that includes the day on which the agreement is entered into.

Subparagraph 110(1)(e)(iv) provides that an employer must comply with this subsection in respect of a security in order to be eligible for the deduction under paragraph 110(1)(e) in respect of the security.

This amendment applies in respect of agreements to sell or issue securities entered into after 2019.

Clause 3

Definitions

ITA
111(8)

Subsection 111(8) of the Act sets out definitions that apply for the purposes of section 111, which contains rules relating to loss carryovers. The definition “non-capital loss” in this subsection applies for the purposes of the Act because of subsection 248(1).

Consequential on the introduction of paragraph 110(1)(e), which provides a deduction to an employer in respect of certain employee stock options, paragraph (b) of the description of E in the definition “non-capital loss” in subsection 111(8) is amended to include amounts deducted by a taxpayer under new paragraph 110(1)(e).

For more information, see the commentary on new paragraph 110(1)(e).

This amendment comes into force on January 1, 2020.

Clause 4

Clarification

ITA
143.3(5)

Section 143.3 of the Act reduces, if applicable, the amount of a taxpayer's expenditure by certain amounts for the purposes of computing the taxpayer's income, taxable income and tax payable or an amount considered to have been paid on account of the taxpayer's tax payable.

Subsection 143.3(5) provides a number of rules that are intended to provide greater certainty. New paragraph 143.3(5)(e) is added, consequential on the introduction of new paragraph 110(1)(e), which provides a deduction to an employer in respect of certain employee stock options.

Paragraph 143.3(5)(e) provides that section 143.3 does not apply to prohibit the deduction of an amount under paragraph 110(1)(e).

For more information, see the commentary on new paragraph 110(1)(e).

This amendment comes into force on January 1, 2020.