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Canadian Tax Alert

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Federal budget 2010 – significant changes to the taxation of CCPC stock options

The 2010 federal budget announced significant changes to the taxation of employee stock options with respect to three areas:

- The taxation of options that are “cashed out”;
- The tax deferral of stock option benefits; and
- Employer withholding obligations.

The proposed changes will generally be effective after March 4, 2010, 4:00 pm EST (the “Effective Time”).

Taxation of stock option “cash outs”

Currently, it is possible to structure option agreements to give an employee the right to either exercise an option to acquire shares or to surrender the option for cash proceeds equal to the fair market value of the shares on the date of surrender less the exercise price. In the latter situation, the cash proceeds are taxed to the employee as a stock option benefit eligible for the 50% stock option deduction on the same basis as if the employee had exercised the option and acquired the shares. Further, the employer is permitted to claim a tax deduction for the cash outlay.

The 2010 federal budget proposes to amend the Income Tax Act (Canada) (the Act) so that the stock option deduction will be available to an employee who surrenders options for cash only where the employer forgoes the corporate tax deduction and certain documentation is provided. For these purposes, “employer” includes any person who does not deal at arm’s length with the employer. The employer must provide evidence in writing to the employee that no deduction is being claimed in respect of the payment made to the employee for the disposition of his or her options and the employee must file this evidence with his or her personal tax return for the applicable tax year.

Based on the wording of the proposed amendment, it appears that the employer election is made in respect of individual employees. However, it is not clear whether the election can be made prior to the date on which the employee surrenders his or her options. For example, can the employer designate options with a cash out feature at the time of grant as being options for which the employer will forgo the corporate deduction? It is also not clear whether a separate election can or must be made in respect of each option award for a particular employee.

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The proposed change in the tax treatment appears to apply to all options disposed of for cash proceeds after the Effective Time. Greater clarity is required to understand whether “grandfathering” is available for existing options.

Tax deferral of the stock option benefit

The rules that allow for a deferral of the stock option benefit in respect of public company shares have been significantly amended by the budget. The deferral of the stock option benefit in respect of shares of a Canadian-controlled private company (CCPC) has not been changed.

Employer withholding obligations

Traditionally, many employers have relied on the Canada Revenue Agency’s (CRA’s) administrative position of “undue hardship” as the basis for not withholding income taxes at source on stock option benefits other than the cash outs noted above. Under the undue hardship policy, an employer was not required to withhold income taxes in respect of stock option benefits from other cash remuneration if the employer was satisfied that to do so would result in financial hardship to the employee. The CRA also administratively permitted the employer to take into account the 50% stock option deduction in determining the taxes to be withheld at source.

The 2010 federal budget eliminates the CRA’s administrative policy of undue hardship with respect to all stock options. However, there is an exception to the new withholding requirements and no tax need be withheld where taxation of the stock option benefit is deferred under the stock option rules pertaining to CCPCs.

Quebec taxation of stock options

The province of Quebec has its own income tax legislation and tax administration. The 2010 federal budget proposals do not affect the province’s taxation of stock options. It remains to be seen whether the Quebec government will adopt parallel measures.

Action steps to consider

The 2010 federal budget will require Canadian companies to carefully review their employee stock options plans.

- Employers should evaluate existing plans with respect to “in the money” options that could be surrendered for cash to determine the cost to the corporation of the forgone tax deduction.
- Employers will be required to determine how important it is, as a matter of compensation policy, to maintain preferential individual tax treatment in the form of the 50% stock option deduction in light of the forgone corporate tax deduction.
- In the future, it will be necessary for employers to be significantly more strategic in granting options that can be surrendered for cash.
- Existing stock option plans should be reviewed by legal counsel to determine whether there is any language that would compel the employer to provide the 50% stock option deduction to employees who elect to surrender their options for cash proceeds.
- On a go-forward basis, it would be prudent for employers to expressly reserve in the plan the right to designate which options with a cash surrender right will be eligible for the 50% stock option deduction.

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