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Canadian Tax Alert

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Federal budget 2010 – significant changes to the taxation of employee 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. It is also unclear whether the proposed changes will apply to options to acquire mutual fund units. While the Notice of Ways and Means Motion generally refers to "securities", a term which would include mutual fund units under section 7 of the Act, the employer election described in the Notice of Ways and Means Motion is only in respect of stock options.

It is important to note that this proposed amendment to the Act does not apply to "cashless exercise" programs. Under a cashless exercise program, the employee does not surrender the option; rather, the employer arranges with a broker for the exercise price to be advanced to the employee and the employee exercises the options with a direction to the broker to immediately sell the shares on the open market to satisfy payment of the exercise price and any applicable tax withholdings.

Tax deferral of the stock option benefit

Currently, taxation of the stock option benefit arising in respect of options to acquire publicly listed shares can be deferred until the year in which the employee sells the shares or is otherwise deemed to have disposed of them (e.g., on death). The employee must file an election before January 16 of the year following the year in which the shares were acquired. The amount that may be deferred cannot exceed the stock option benefit arising on $100,000 worth of options that vest in a particular year (based on the value of the shares at the time of grant), and the optionholder must be eligible to claim the 50% stock option deduction.

However, in the year in which the employee sells the shares, the employee will be liable to pay the tax owing on the stock option benefit regardless of the value of the shares at the time of sale. In recent years, this lingering liability has been a significant problem for many individuals where the share value has declined to an amount that is less than the tax liability on the stock option benefit. The 2010 federal budget proposes to amend the stock option deferral rules in two respects.

First, individuals will be able to make an election to limit the tax liability on the deferred stock option benefit to the ultimate sale proceeds received. The elective relief will be adjusted to take into account the capital losses arising from the disposition of the shares and their application against capital gains from other sources. This election will be available for shares sold before 2015 (including shares sold before the federal budget announcement). For shares sold before 2010, individuals will be required to file the election by the filing due date for their 2010 personal tax returns.

Second, while the tax deferral of the stock option benefit arising on the exercise of options to acquire Canadian-controlled private corporation (CCPC) shares remains, no deferral elections will be allowed for publicly listed shares acquired after the Effective Time, unless the options initially qualified for the deferral available in respect of CCPC shares and the options have retained this status.

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. 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. In addition, where an individual made a valid deferral election, the Act exempted employers from the requirement to withhold income taxes at source in respect of the deferred stock option benefits.

Recently, the CRA clarified that its administrative position of undue hardship did not apply to stock options exercised by non-resident employees or to cashless exercise programs. The 2010 federal budget extends this position and eliminates the CRA's administrative policy of undue hardship with respect to all stock options. Further, it appears that a tax liability that arises as a result of a stock option benefit may no longer qualify for a formal reduction of tax withholding under subsection 153(1.1) of the Act.

For options exercised after 2010, income taxes will be required to be withheld on stock option benefits as if the amounts had been paid to the employee in cash, subject to the following exceptions:

- If the stock option benefit qualifies for the 50% stock option deduction, the amount of the tax required to be withheld can be reduced to reflect this deduction (e.g., if the gross stock option benefit was $50,000 and the options qualified for the 50% stock option benefit, tax withholdings would be calculated on $25,000).
- No tax withholding is required where the individual must retain the shares for a period of time, provided:
  - the options were granted before 2011 pursuant to a written agreement entered into before the Effective Time; and
  - the agreement, at that time, included a written condition that restricts the employee from disposing of the shares for a period of time after the option exercise.
- 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 (the Taxation Act) 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, as well as non-Canadian companies who grant options to employees of their Canadian affiliates, to carefully review their employee stock options plans.

Stock option cash outs

- 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.
- Employers should consider the accounting impact of the loss of the deduction on their financial reporting.
- In the future, it will be necessary for employers to be significantly more strategic in granting options that can be surrendered for cash.
- Employers should evaluate other compensation alternatives. It should be noted that stock options, even with a cash settlement feature, will continue to be exempt from the salary deferral arrangement rules and, consequently, may still offer tax advantages in comparison to a cash bonus plan.
- 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.
- These proposals will also impact corporate acquisitions where the purchaser requires outstanding options to be surrendered as part of the acquisition.

Stock option deferrals

- Employers should communicate to employees that it will no longer possible after the Effective Time to defer taxation on the stock option benefit where they exercise the option and hold the shares.
- Employees should also be advised of the opportunity to limit taxation of the deferred stock option benefit to the proceeds received on the actual sale of their shares where the share value has declined.
- In certain situations, employers will be required to track CCPC options. For example, in the high tech industry, it is not uncommon for employees to receive options prior to an IPO and then convert their options to those of the publicly traded company. With the abolition of the deferral election for publicly traded shares, tracking the “converted” options that continue to be held by individuals will be very important because, under the Act, the converted options maintain their CCPC status.

Employer withholding obligations

- Employers must review their current procedures for withholding on stock options. Note the definition of “employer” under the Act is very expansive and includes non-resident employers who pay remuneration to Canadian resident employees and non-resident employees who perform employment services in Canada. Where a parent company grants stock options to employees of its Canadian affiliate, the parent company is responsible for withholding and reporting of the stock option benefit unless the costs are recharged to the Canadian entity. In practice, the Canadian entity typically reports the stock option benefit and assumes the withholding obligation (subject to the CRA’s former administrative policy of undue hardship) and the CRA has administratively accepted this practice. However, in light of the new withholding

obligations, it will be important for the Canadian entity and its parent company to develop a co-ordinated withholding process.

- Employers should consider establishing a “cashless exercise” program in order to ensure that their tax withholding obligations are met.
- Employers will be required to track the option exercises of former employees and may wish to consider mandatory language requiring former employees to automatically sell a portion of the shares to cover the applicable withholding taxes.
- With respect to existing option grants, employers should consider whether the employees are required to hold the shares for a certain period of time following exercise, thereby meeting the exception to the withholding obligation. Many companies have corporate share ownership guidelines that require senior executives to maintain a certain level of shareholdings. It is not clear whether such policies would qualify as an agreement that restricts the employees from disposing of the shares. Consequently, the new withholding obligations may force senior executives to dispose of a portion of their shares to satisfy tax withholdings, contrary to the corporate compensation and governance policies of their employers. However, it is possible that certain restricted shares would meet the exception such that no withholding would be required.
- Employers may wish to consider making loans to executives to cover tax withholdings where not prohibited from doing so under corporate governance policies or securities regulations.
- Other equity compensation programs that are governed by section 7 of the Act, such as employee stock purchase plans, will be subject to the new withholding rules and should be included when developing a tax withholding process.

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