

Budget 2010: taking stock of your options

Stock option plans represent a key tool for Canadian employers in compensating, rewarding and retaining a qualified workforce in a manner that aligns the interests of company owners and employees. The structuring and operation of many such plans will be impacted by the tax measures contained in the federal budget that was tabled on March 4, 2010.

In summary, the measures contained in Budget 2010 will, if enacted: (i) deny a deduction to an employer in respect of any option cash-out payment in circumstances where an employee is seeking to claim a deduction under paragraph 110(1)(d) of the *Income Tax Act* (Canada) (the “**Tax Act**”) in respect of the payment; (ii) clarify the tax consequences of an employee disposing of stock option rights to a non-arm’s length person; (iii) require more stringent income tax withholding requirements in respect of stock option benefits; (iv) eliminate the deferral of taxation potentially available with respect to benefit amounts realized on the exercise of certain public company stock options; and (v) provide relief to certain taxpayers with deferred option benefits in circumstances where there has been a substantial decline in the value of the underlying shares.

stock option cash-outs

Under the existing rules in the *Tax Act*, an employee who acquires a security under a stock option agreement (“**option exercise**”) or otherwise disposes (at his or her option) of his/her rights under such an agreement to an arm’s length party (“**option cash-out**”) will generally realize an employment benefit (“**benefit amount**”) equal to, (i) in the case of an option exercise, the amount by which the fair market value of the security at the time the option was exercised exceeds the amount paid by the employee to acquire the security and any amount paid to acquire the option, and (ii) in the case of an option cash-out, the amount of the cash payment less any amount paid for the option.¹ Where certain conditions are satisfied, the employee will be entitled to claim a deduction equal to one half of the benefit amount (the

¹ Different rules can apply with respect to stock options issued by “Canadian-controlled private corporations”.

“employee deduction”), which effectively results in the benefit amount being taxed at rates comparable to those applied in respect of capital gains. From the employer’s perspective, the Tax Act generally prohibits the deduction by the employer of the benefit amount in the case of an option exercise, but does not generally prohibit a deduction in the case of an option cash-out payment (assuming the employer has paid or otherwise borne the related costs).

With the objective of eliminating what the Government views to be an inappropriate double deduction opportunity in the context of option cash-out transactions, three quarters of the benefits from which, according to the Government, are being claimed by taxpayers making more than \$500,000 per annum, Budget 2010 proposes to amend the Tax Act such that an employee realizing a benefit amount in connection with an option cash-out transaction occurring after 4:00 pm (EST) on March 4, 2010 (the “Effective Time”) will only be entitled to claim the employee deduction in respect of such benefit amount where the employer makes a valid election to forgo a deduction on its part (and on the part of all parties not dealing at arm’s length with the employer). It would appear from the “Notice of Ways and Means Motion” accompanying Budget 2010 that this employer-initiated election may only be available with respect to options issued after the Effective Time; however, the Department of Finance (Canada) has informally advised us that the employer election is intended to be available with respect to all options cashed-out after the Effective Time, regardless of when the options were issued.

disposition of stock option rights to non-arm’s length parties

Budget 2010 indicates that the Tax Act will be amended to “clarify” the Government’s position that an employee disposing of stock option rights to a non-arm’s length person will potentially realize an employment benefit at the time of the disposition. It is not clear how the Tax Act will be amended to reflect this proposed measure, which would appear to reflect a departure from the existing rules in the Tax Act (specifically, paragraphs 7(1)(c) and (d) of the Tax Act provide that the relevant benefit amount is generally to be computed and included in income once the relevant non-arm’s length transferee has exercised the subject option or otherwise disposed of the option rights to an arm’s length party).

elimination of tax deferral election for public-company stock options

The current provisions of the Tax Act provide an opportunity, within specified limits² and subject to certain conditions³, for an employee to defer the benefit amount associated with the exercise of options relating to shares listed on a “designated stock exchange” (defined to include most of the world’s major exchanges) until the year in which the relevant shares are disposed of (the general rule, as noted above, is to tax the benefit amount in the year the option is exercised). Where eligible, the employee must file an election form to obtain the deferral.

Budget 2010 proposes to eliminate the deferral entitlement in respect of any options exercised after the Effective Time. It is understood that this change was motivated by a desire on the Government’s part to eliminate the potential for financial difficulties arising where the securities with the associated deferred option benefit amount substantially decline in value (leaving the employee without the ability to pay the applicable tax on the benefit amount).

special relief for taxpayers who made deferral elections

Budget 2010 makes reference to the financial difficulties experienced by a number of taxpayers who opted to defer the taxes payable on their option benefits and then watched the value of the optioned securities decline (in many cases to the point that the value of the securities is less than the deferred tax liability).

To provide relief for taxpayers in these situations, Budget 2010 proposes to introduce special elective tax treatment for taxpayers who deferred stock option benefit amounts. In effect, the special elective treatment will ensure that the tax liability on a deferred stock option benefit does not exceed the proceeds of disposition of the optioned securities, taking into account tax relief resulting from the use of capital losses on the optioned securities against capital gains from other sources.

Only stock option benefits for which an election to defer taxation has been made will qualify for this special elective tax treatment. In addition, individuals who disposed of their optioned securities before 2010 will have to make the election on or before their filing-due date for the 2010 taxation year (generally, April 30, 2011). Individuals who have not disposed of their optioned securities before 2010 must do so before 2015 in order to qualify for this special elective treatment (they will then have until their filing-due date for the taxation year of disposition to make the election).

² Generally, the deferral entitlement applies to options vesting in a particular year with a “*specified value*” not exceeding C\$100,000 (for this purpose, the “*specified value*” of an option means the number of underlying shares to which the option relates multiplied by the fair market value of such shares at the time the option is granted).

³ For example, the employee must be a Canadian resident at the time the option is exercised, and the options cannot have an exercise price that is less than the fair value of the underlying shares at the time of grant.

clarifications concerning employer remittance obligations

In addition to eliminating the deferral alternative with respect to qualifying options in publicly-traded companies, Budget 2010 proposes to clarify the obligation on the part of an employer to make source deductions and remit tax in respect of stock option benefit amounts as though such benefit amounts had been paid to the employee in cash. The clarification, which arguably represents a departure, in many cases, from existing administrative policy, will apply to benefits arising on the issuance of securities after 2010, in order to provide time for businesses to adjust their compensation arrangements and payroll systems accordingly.

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a cautionary note

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted. © McMillan LLP 2010.